MID-YEAR ECONOMIC OVERVIEW OF THE FY 1983 BUDGET

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

JULY 27, 1982—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

JULY 28, 1982—VIEWS OF THE FEDERAL RESERVE SYSTEM

AUGUST 3, 1982—VIEWS OF THE OFFICE OF MANAGEMENT AND BUDGET

AUGUST 4, 1982—VIEWS OF THE SECRETARY OF THE TREASURY

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CONTENTS

HEARINGS

	Page
July 27, 1982—Views of the Congressional Budget Office	1
July 28, 1982—Views of the Federal Reserve System	37
August 3, 1982—Views of the Office of Management and Budget	91
August 4, 1982—Views of the Secretary of the Treasury	127

STATEMENTS BY COMMITTEE MEMBERS

Chairman Domenici	1, 37, 91, 127
Senator Hollings	38
Senator Sasser	93

WITNESSES

Regan, Hon. Donald T., Secretary of the Treasury	127
Prepared statement	134
Rivlin, Alice M., Director, Congressional Budget Office	2
Stockman, David A., Director, Office of Management and Budget	94
Prepared statement	101
Volcker, Paul A., Chairman, Board of Governors, Federal Reserve System	39

ADDITIONAL MATERIAL

Statement of Chairman Volcker before the Senate Committee on Banking, Housing and Urban Affairs, July 20, 1982	172
Midyear Monetary Policy Report to Congress, Board of Governors of the Federal Reserve System, July 20, 1982	196

VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

TUESDAY, JULY 27, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:34 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Andrews, Symms, Kasten, Quayle, Gorton, Chiles, Biden, Johnston, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The hearing will please come to order.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Dr. Rivlin, you are welcome today; it is my privilege to welcome you. The Congressional Budget Office assessment of the state of the economy and the Federal budget is important to us. We are pleased that you are here to discuss these matters.

We look forward to your views on the economy as a guide as we prepare for the possibility of a second concurrent budget resolution. We also look forward to your appraisal of Congress current actions to reduce the deficit and the effect of these actions on interest rates and the economy.

Because we are starting a series of hearings, I think it is appropriate for me to make two brief observations to put this hearing and the ones that will follow into context.

SUPER OPTIMIST

First, Congress has come a long way in developing and implementing this year's budget; 6 months ago, few people thought we would get a budget at all. The optimists foresaw a stalemate; the pessimists talked about disintegration of the whole process.

I myself would probably have been classed as a super optimist because I thought we had a 50–50 chance of adopting a budget. Today, we not only have a budget, but one with substantial actions to reduce our Nation's deficits during the next 3 years.

Significantly, the Senate has already acted to pass the legislation, as you well know, Dr. Rivlin, to reduce the budget deficit $118 billion over the next 3 years. Although the budget may not be per-

fect in everyone's eyes, it is certainly an important and essential step in the process of reducing the size of our prospective deficits.

ECONOMY IMPROVING

The second observation that I would like to make is that while the economy is not showing the strength we would like, it is about where we expected it to be at this point. Dr. Rivlin, I hope you will comment directly on this, but as I understand it, the economy is showing signs of recovering. Similarly, unemployment and interest rates are about where we expected them to be.

In short, my understanding is that our economic assumptions in the first budget resolution, considering the historic accuracy of such, are about on track, except for inflation which is somewhat better than we assumed.

It appears to me that the real issue before the committee today is what we can expect from the economy now and through the budget period. Likewise, it seems that we ought to get your views on whether or not we should continue to carry out the policies as stated in the budget resolution.

I yield now to Senator Kassebaum, and then we would be delighted to hear from you, Dr. Rivlin.

Senator KASSEBAUM. I really have no further comments to add, Mr. Chairman, except to say to Dr. Rivlin that I have admired in the time since I have been on the Budget Committee—when I was elected in 1978 until now—her ability at CBO to try and hold a steady course while many others around are trying to juggle figures here and there and to find facts to fit the assumptions that we wished to make.

I have come to admire greatly the integrity of CBO, and I think it is terribly important that we can have some confidence in projections that the Congressional Budget Office makes.

Chairman DOMENICI. Dr. Rivlin, we have your prepared remarks and you can give them in detail. I want to announce that from my standpoint, I only have two other meetings at the same time. One has already started and one starts at 10, so I may have to leave. I do have three or four questions, but I think I would prefer to have you testify first.

Dr. Rivlin, you may start, please.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

BUDGET PROCESS STRONG

Dr. RIVLIN. Thank you very much, Mr. Chairman and Senator Kassebaum. I appreciate the opportunity to be here again. Let me say that I think that the congressional budget process, largely due to the leadership of this committee, has proved extraordinarily strong in the face of very great difficulties this year—a difficult economic situation; deficits that threatened to escalate rapidly if the Congress did not take very difficult action both on the spending side and on the tax side to arrest the increase.

It was, as you pointed out, a situation in which there were, and there still are, many who doubted that the Congress could take dif-

ficult action and could make a budget in an election year. So far, you are on track and I am very proud of the whole process.

Let me go through my statement, which is not extremely long, and then I will be prepared to answer any questions that you or Senator Kassebaum have.

In my testimony today, I will discuss recent economic developments, provide a preliminary Congressional Budget Office economic projection, and discuss the implications of this projection for the budget outlook.

PROJECTED VIGOROUS SECOND HALF

Last February, as you will remember, CBO projected fairly vigorous economic growth in the second half of this year for three reasons. First, the inventory adjustment would have run its course. Second, consumer spending would be stimulated by the July tax cut and the social security benefit increase. Third, declining interest rates would encourage a pickup in sales of housing and other interest-sensitive durable goods. Lower interest rates would also eventually lead to a recovery in investment spending.

CBO still expects the economy to revive in the second half of 1982. However, the failure of interest rates to decline, despite falling inflation, and the unexpected depth of the recession now lead us, as well as most other forecasters, to anticipate a somewhat less robust recovery than seemed likely a few months ago. Moreover, the especially weak performance of investment spending in the recent period, resulting from high interest rates and record economic slack, has created doubts about whether the recovery will prove sustainable with policies currently in place.

Most economic forecasters project moderate growth in output and employment and further progress in reducing inflation during the next few years. In our view, however, the level of uncertainty is much greater than the similarity of forecasts might suggest. Economic policies themselves account for some of the uncertainty. The budget changes enacted during the last year are of such large magnitude by historical standards that we cannot confidently predict their economic effects. Moreover, the unusual combination of tight monetary policy designed to reduce inflation and expansionary fiscal policy has also contributed to the uncertainty.

RECENT ECONOMIC DEVELOPMENTS

As measured by constant dollar GNP, the decline in economic activity during the past year exceeded the average decline in postwar recessions. Moreover, there was a large amount of slack in the economy before this recession began. High interest rates aborted the recovery from the 1980 recession when it was less than a year old. As a result, there has been very little economic growth since the end of 1979 and unemployment has recently reached postwar record levels.

High unemployment is now widespread and some groups have been particularly affected. The combination of recession and longer run structural problems has produced severe economic distress for some industries, such as steel and automobiles, and for some parts of the country, especially in the industrial Midwest. Recession,

combined with high interest rates, has aggravated problems in housing and agriculture.

Last February when CBO published its forecast for the first budget resolution for fiscal year 1983, we expected that the decline in economic activity would be somewhat less severe than the average recession and would end in the spring. Revised GNP data now show that the decline in economic activity was deeper than CBO had projected last winter, and as a result unemployment rose higher than expected. As table 1 shows, GNP did turn up in the second quarter, but only because of a reduction in the liquidation of inventories. Real final sales, which declined through the second quarter, were weaker than expected. Most of the unanticipated weakness in final sales in the second quarter can be traced to consumer spending.

TABLE 1.—MAJOR ECONOMIC INDICATORS

	Calendar years—			Quarters—				
				1981			1982	
	1979	1980	1981	II	III	IV	I	II
Billions of 1972 dollars:								
GNP	1,479.4	1,474.0	1,502.6	1,502.2	1,510.4	1,490.1	1,470.7	1,476.8
Final sales	1,472.2	1,479.0	1,493.7	1,490.1	1,493.9	1,485.3	1,486.1	1,483.7
Inventory change	7.3	−5.0	9.0	12.1	16.5	4.8	−15.4	−6.9
Disposable income	1,015.7	1,018.0	1,043.1	1,036.6	1,048.8	1,051.9	1,046.9	1,054.9
Percent change at an annual rate:								
GNP	2.8	−.4	1.9	−1.5	2.2	−5.3	−5.1	1.7
Consumption	2.7	.3	1.8	−2.7	2.9	−2.3	2.5	3.0
Business fixed investment	7.3	−2.2	3.5	1.1	9.3	.6	−5.0	−8.5
Residential investment	−5.2	−20.2	−4.8	−17.4	−31.9	−25.3	−10.2	3.3
Federal purchases	1.8	4.2	3.7	−3.2	14.8	20.4	−5.5	−16.1
Defense	2.6	4.0	4.9	11.5	7.6	10.1	−7.9	7.1
Nondefense	.3	4.6	1.3	−27.4	31.6	43.6	−.9	−49.2
State and local purchases	1.1	1.1	−.8	−4.6	−2.7	−.8	−1.1	.4
Exports	15.4	8.9	−.4	1.0	−4.7	−2.4	−12.7	1.8
Imports	6.1	−.4	7.2	16.8	11.3	6.0	−17.5	7.2
GNP deflator	8.6	9.3	9.4	6.8	9.0	8.8	4.3	5.3
CPI-Urban consumers	11.3	13.5	10.3	7.8	11.8	7.7	3.2	4.6
Industrial production	4.4	−3.6	2.7	1.9	1.3	−16.4	−11.7	−6.9
Percent:								
Unemployment rate	5.8	7.1	7.6	7.4	7.4	8.4	8.8	9.5
3-month Treasury bill rate	10.1	11.4	14.0	14.9	15.1	11.8	12.8	12.4
Capacity utilization rate	85.5	79.1	78.5	79.8	79.3	74.8	71.6	70.3
Personal saving rate	5.9	5.8	6.4	6.1	6.5	7.5	6.6	6.6

INFLATION DECLINE DUE TO RECESSION

The depth of the recession has been a major factor in the decline in inflation. For the first 6 months of 1982, the inflation rate, as measured by the GNP deflator, was nearly 2 percentage points lower than projected last February. The sharp reduction in inflation from 8.9 percent during the second half of 1981 to 4.8 percent during the first half of this year reflected several things: Very weak commodity prices, particularly for gasoline and crude oil; sluggish final demands; the rise and continued strength of the dollar in foreign exchange markets, which have held down the cost

of imported goods; and lower wage demands, including some reopening of wage contracts, as a result of record unemployment rates.

The most unexpected development thus far in 1982 has been the extremely high interest rates, as shown in table 2.

TABLE 2.—FINANCIAL VARIABLES

	1979	1980	1981	1981 (quarters)				1982 (quarters)	
				1st	2d	3d	4th	1st	2d
Monetary growth (percent):									
M_1	7.7	6.3	7.0	4.6	9.6	0.2	5.9	10.8	3.2
M_2	8.5	8.3	9.8	7.7	12.6	8.6	9.2	10.1	9.7
Total reserves [1]	1.6	5.8	6.5	5.6	4.2	4.0	3.2	8.3	NA
Interest rates (percent):									
3-mo Treasury bill	10.1	11.4	14.0	14.4	14.9	15.1	11.8	12.8	12.4
20-yr Government bond	9.3	11.4	13.7	12.7	13.5	14.5	14.1	14.3	13.7
Moody's AAA	9.6	11.9	14.2	13.2	14.0	14.9	14.6	15.0	14.5
Mortgage rate [2]	10.9	12.8	14.9	13.9	14.6	15.4	16.1	15.7	15.9
Treasury borrowing:									
Billions of dollars	37.4	79.2	87.4	128.9	43.4	56.3	120.9	120.0	NA
Absorption rate [3]	9.5	22.2	22.6	30.9	10.4	15.2	35.0	29.5	NA

[1] At Federal Reserve member banks.
[2] Effective conventional mortgage rate, all homes, combined lenders.
[3] Percent of all funds raised by nonfinancial institutions, private and public.
Source: Federal Reserve Board, Federal Home Bank Board.

Rates declined quite sharply in the first months of the recession, but then rose again in the fall and winter. As a result, many interest rates were higher in the first 6 months of 1982 than in the fourth quarter of last year, despite the deepening recession and the decline in inflation. Figures 1 and 2 show that both short and long-run interest rates were at exceedingly high levels compared with earlier recessionary periods. In fact, in recent months interest rates adjusted for current inflation reached their highest level since 1932. These high rates contributed to the record level of business failures and delayed the recovery in interest-sensitive sectors of the economy.

FIGURE 1

Three-Month Treasury Bill Rate

Around Peak Quarters

Adjusted for Current Underlying Inflation

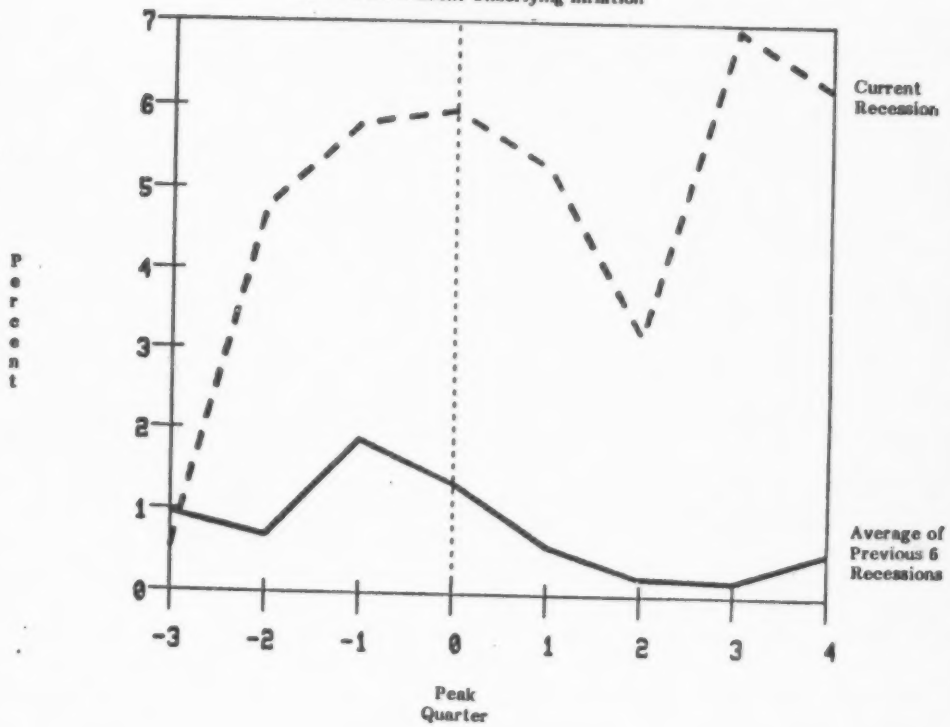
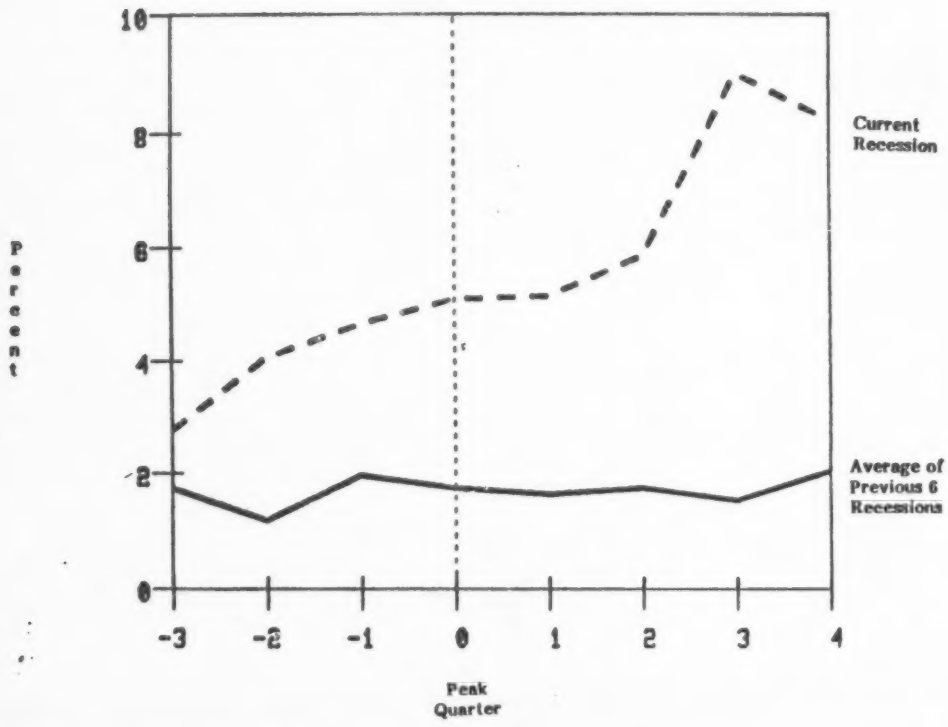


FIGURE 2

AAA Corporate Bond Rate

Around Peak Quarters

Adjusted For Current Underlying Inflation



During recent weeks, interest rates have declined moderately—and they declined more today, which is encouraging. They are forecast to continue to fall, perhaps irregularly, for the remainder of the year. Whether such a decline does in fact materialize is critical because substantial further interest rate reductions appear to be necessary if the economic recovery is to be sustained.

Although real GNP turned up in the second quarter, it is not clear whether the turning point in economic activity has been reached. The latest data on economic activity give mixed signals. On the positive side, real GNP did rise 1.7 percent at annual rates in the second quarter, according to preliminary estimates, and the Commerce Department's index of leading indicators has risen for 3 consecutive months—usually a sign of imminent upturn. Real consumer spending and residential construction were up and the inventory liquidation slowed in the second quarter—all positive signs for the future. Unemployment insurance claims have also declined for more than 1 month. On the other hand, the economy seemed to weaken in June and many important economic indicators, such as industrial production, still show no evidence of recovery. Moreover, the decline in business investment accelerated in the second quarter, and weak orders for capital goods suggests that excess capacity

and the record-high real interest rate will have an adverse effect on business investment for several more months.

The most positive sign of recovery is the rise in real disposable income—by about 3 percent at annual—rates in the second quarter and the expected sharp rise in this quarter as a result of the personal income tax cut. Because of these developments, consumer spending should turn up significantly in the months ahead. However, high interest rates and recently enacted tax incentives for saving could restrain the recovery in consumer spending during the months ahead.

THE CBO FORECAST

Although CBO has not yet assimilated the extensive revisions in GNP released last week by the Commerce Department, we have prepared a preliminary economic forecast, which is shown in table 3.

TABLE 3.—COMPARISON OF THE PRELIMINARY CBO FORECAST AND THE ECONOMIC ASSUMPTIONS OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1983

Economic variables	Actual [1]	Projected	
	1980:4 to 1981:4	1981:4 to 1982:4	1982:4 to 1983:4
Nominal GNP (percent change):			
CBO	9.6	6.8	10.1
Resolution	9.8	8.6	11.6
Real GNP (percent change):			
CBO	.7	.7	3.6
Resolution	.9	1.6	4.4
GNP implicit price deflator (percent change):			
CBO	8.9	6.0	6.3
Resolution	8.9	6.9	6.9
Unemployment rate (percent, calendar year average):			
CBO	7.6	9.3	8.8
Resolution	7.6	9.1	8.4
3-mo Treasury bill rate (percent, calendar year average):			
CBO	14.0	12.0	11.1
Resolution	14.0	12.0	10.7

[1] The difference between CBO and resolution figures reflects the recent revision in historical GNP accounts.

This forecast shows moderate growth in real GNP during the second half of this year—in other words, the same pattern we were expecting last February—continuing at a rate of more than 3.5 percent during 1983. The unemployment rate is expected to begin a gradual decline later this year, resulting in an average unemployment rate of 9.3 for this year and 8.8 for 1983.

Inflation, as measured by the GNP deflator, is expected to accelerate from the very low 4.8-percent average annual quarterly rate in the first half of this year to about 7 percent in the last 6 months of the year. Two of the factors accounting for this rise in the second half of 1982 are the usual temporary acceleration due to the concentration of Federal pay raises in the fourth quarter and the effect of recent increases in oil prices.

Next year the inflation rate is expected to decline to about 6.3 percent on a fourth-quarter-to-fourth-quarter basis. Both long- and short-term interest rates are expected to trend down during the

forecast period, although short-term rates are expected to move up somewhat in 1983 as the recovery progresses. Our projection shows an average annual rate for 3-month Treasury bills of about 12 percent this year and about 11 percent in 1983.

The CBO forecast is based on the assumption that the policies of the first resolution for fiscal year 1983 will be carried out. In regard to monetary policy, the CBO forecast assumes that M_1 will grow at the upper end of the Federal Reserve's target range of 5.5 percent during the next 1½ years.

The forecast of inflation assumes that food prices will rise about 5 percent this year and 6.5 percent next year. World oil prices are assumed to show no significant change through 1983.

The projected economic recovery is characterized by a pickup in consumer expenditures, particularly for durable goods; a further increase in residential construction, though the level remains depressed; an end to the inventory liquidation before yearend; continued rapid growth in defense purchases; and further declines in business investment spending this year followed by an upturn during 1983. The recovery results from three factors:

First, the current low level of inventories.

Second, the two reductions in personal income taxes that provide a considerable boost to real disposable income and personal consumption expenditures and the cuts in business taxes. The tax cuts are quite large, and lower projected inflation increases the real value of both the individual income tax cuts and the expanded business appreciation allowances.

Third, a projected decline in interest rates that is expected to set free pentup demands for interest-sensitive durable goods. Moderate consumer debt burdens suggest that the consumer spending rebound could be sizable. The CBO forecast, however, does not foresee an easing of credit conditions sufficient to permit a rapid recovery in residential construction or in business investment during the forecast period.

Compared with the economic assumptions adopted for the first resolution, also shown in table 3, the updated CBO forecast shows slightly less growth and lower inflation, a result of actual developments since the first resolution forecast was made. Although the differences are small and easily within the range of usual forecast error, such small differences in economic assumptions can have significant consequences for budget estimates.

RISKS IN THE FORECAST

At present, the major source of uncertainty appears to be the behavior of interest rates. The outlook for interest rates is particularly clouded because there does not appear to be a completely satisfactory explanation for the high rates of the past year.

The widely accepted explanation for the exceedingly high long-term rates experienced during recent months is that investors anticipate that a resurgence of inflation and/or high Federal deficits will place upward pressure on rates in years to come. The high short-term rates are not so easily explained. Most economists would expect that declining inflation and a recession would lead to weak credit demands and declining interest rates, providing Federal Re-

serve policies were unchanged. Thus, analysts were surprised by the rise in short-term rates in the first half of 1982, especially given the increased growth in the money supply during that period. The apparent reason for this rise was that the demand for money was uncharacteristically strong. According to Federal Reserve spokesmen, much of the growth in M_1 reflected the desire of individuals to increase liquid balances for precautionary purposes—money to hold, not money to spend. Economists did not anticipate this development because deposits included in M_1 generally pay lower interest rates than other liquid assets, such as money market mutual funds. By permitting money aggregates to grow above target for much of the last 7 months, the Federal Reserve partially accommodated this increased demand for liquidity, but apparently not sufficiently to prevent rates from rising.

Unfortunately, this explanation does not provide much information for projecting the future because we do not know whether the increased demand for liquidity is permanent or will soon be reversed. There is some reason to think that precautionary demand could decline as the economic recovery proceeds, but this cannot be predicted with confidence on the basis of past experience. If precautionary demand declines, short-term interest rates may fall quickly without an increase in money growth targets. Otherwise, short-term rates might remain quite high under current monetary policy.

If past cyclical changes in interest rates are a guide to the future, the decline in short-term rates could be quite large. Between its August 1981 peak and June of this year, the 3-month Treasury bill rate declined about 3.5 percentage points, reversing nearly half of the previous cyclical rise. During past declines, however, the bill rate fell by between 1¼ and ⅔ times the earlier rise. If this historical pattern is repeated, the bill rate might decline further by 2 to 7 percentage points from the June levels—a decline that could set in motion a vigorous recovery. Most forecasters, however, believe that such a large decline in rates is unlikely in view of monetary policy targets and the projected magnitude of Treasury borrowing.

THE BUDGET OUTLOOK

Turning finally to the budget outlook, CBO has not undertaken a comprehensive review of budget estimates pending receipt of the administration's midsession review. Nevertheless, I can make a few comments on the status of the fiscal year 1982 budget and the implications of our preliminary economic forecast for fiscal year 1983.

Based on actual tax collections through June, it now appears that fiscal year 1982 revenues will be in the range of $620 to $625 billion, or $3 to $8 billion below the revised second budget resolution estimate. Outlays will probably be close to the resolution level of $734 billion, based on actual spending trends to date. Primarily because of the lower-than-expected revenues, the budget deficit for 1982 will probably exceed the resolution target of $106 billion by several billion dollars.

While the preliminary CBO forecast for fiscal year 1983 is only marginally different from the economic assumptions used for the

first budget resolution, these marginal differences could result in surprisingly large budget reestimates, especially for revenues. The lower-than-expected revenue base for 1982, combined with the slightly lower real growth and lower inflation for 1983 in the CBO forecast, imply appreciably lower revenues than estimated for the first resolution. The impact of the CBO forecast on outlays is smaller, as effects of the lower inflation offset to some extent the effects of higher unemployment and interest rates. The net effect of these reestimates could be to add $25 to $35 billion to the 1983 budget deficit, almost all of it on the revenue side.

For the longer run, the CBO forecast also implies higher budget deficits than projected for the first resolution. The principal reason would be lower revenues resulting from the somewhat lower real growth and lower inflation than assumed for the resolution. Outlays would be only marginally higher. The net result could be to increase budget deficits by $40 to $55 billion for 1984 and $50 to $65 billion for 1985.

There is a great deal of uncertainty about the economic and budget outlook. It is certainly possible that the economy could recover more rapidly than projected by CBO because of easier credit conditions. Lower interest rates could provide a large boost to residential construction, business investment, and other interest-sensitive durable goods. Under this scenario, real output could expand more rapidly than we now project. Assuming that inflation does not respond quickly to stronger demands, the implications for the budget will be higher revenues and somewhat lower outlays.

On the other hand, of course, if interest rates continue at high levels, the projected economic recovery could be severely limited. This low-growth scenario would result in even lower revenues, higher outlays, and significantly higher deficits.

CONCLUSION

In conclusion, Mr. Chairman, the CBO still expects a recovery in the second half of this year and continued reduction of inflationary pressures. Recent economic trends, however, have led us to project a more moderate growth and less inflation than we anticipated last February. Both of these changes in the economic outlook lead to estimates of larger budget deficits. This illustrates the sensitivity of Federal budget changes to economic conditions.

Even the relatively small changes in economic outlook now forecast by CBO could have substantial effects on budget estimates. At best, budget deficits will continue to be a problem for the foreseeable future, even with the tax changes and spending reductions assumed for the first budget resolution. Further tax changes and additional spending reductions could be required again next year to achieve the longer run deficits specified by the budget resolution.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Dr. Rivlin.

I assume a number of Senators have conflicting schedules. I myself have to leave in about 30 minutes. Senator Gorton, do you have a conflicting meeting?

Senator GORTON. I am going to leave now.

Chairman DOMENICI. You are going to leave now.

Senator Quayle, can you be here for a while?

Senator QUAYLE. I have another meeting at about 10:30. I could stay a little bit beyond that, but not a whole lot.

Chairman DOMENICI. What about on your side, Senator Chiles?

Senator RIEGLE. Well, we are meeting in the Banking Committee as well this morning, but I want to stay until we have had a chance to cross-examine.

Chairman DOMENICI. Yes; I was just thinking, from my standpoint I will be very brief and then turn it over to Senator Chiles. Maybe we can accommodate ourselves here if you could plan to stay maybe 45 minutes, so we might——

Senator QUAYLE. I could probably stay until 11, but not beyond 11, because I have got a meeting at 10:30.

Chairman DOMENICI. All right, fine.

FIRST RESOLUTION REDUCES DEFICITS—SUBSTANTIALLY

Dr. Rivlin, I want to thank you for your statement and your analysis. In the CBO's analysis earlier this year, it was projected that the 1985 deficit would be approximate $240 to $250 billion. Do you recall that?

Dr. RIVLIN. That was before cuts.

Chairman DOMENICI. Correct.

Dr. RIVLIN. Right.

Chairman DOMENICI. Now, it seems obvious to me that even with any reestimating that may have to take place in the outyears because of what you have given us today, we will not have deficits of this magnitude if we implement the policies of the first budget resolution.

Is that correct? Have we made substantial progress toward deficit reduction if we implement the resolution and its policies?

Dr. RIVLIN. Very much so, Mr. Chairman. The Congress has taken very strong action to reduce what would otherwise have been a rapidly escalating prospective deficit.

OUTYEAR DEFICITS CAUSED BY ECONOMY

Chairman DOMENICI. Now, you frequently hear a myth that all of these deficit reestimates arise because Congress overspends. That is not to say that the budget in every respect is under control. But I gather from your testimony, in terms of your projections, the increases that might occur in the outyears in the deficits are not due to overspending, but are due to an economy that has not recovered, and principally because revenue estimates will not be as high as we might have previously expected.

Is that correct, and if we do not continue with these policies, do you think that we take a risk of making the recovery less likely?

Dr. RIVLIN. Yes, I do, Mr. Chairman. You are correct that the tentative ranges of possible deficit increases that I mention in my statement have nothing to do with actions of the Congress whatever. They assume that the policies of the first resolution will be carried out, but they reflect the possible weakening of the economy and the possible effect of improved inflation.

It is not all bad news. The deficits might be larger because the growth rates might be lower but also because inflation might im-

prove more rapidly than you expected it to. Both of these changes affect the budget primarily on the revenue side. They cut into expected revenues that otherwise might have been collected.

So, these are economic effects, not congressional effects. They are similar to what happened to you last year when you started with much lower deficit estimates. Those estimates have risen very rapidly, not because of actions taken by the Congress, but because this year the economy went into recession not predicted by either us or the administration. And the effect of that recession—primarily on the revenue side—was to increase the deficits very substantially.

The Congress, of course, has taken action to reduce the prospective deficits. In my view, that is conducive to longer run growth. One of the things inhibiting recovery is the prospect of large deficits, and the possible effect of that on interest rates as the economy recovers. It is necessary to insure that the recovery will take place to get those prospective deficits down.

Chairman DOMENICI. I am going to yield to Senator Chiles now, and I do not think we will keep the clock, but let us try to stay at 5 minutes if we can.

Senator CHILES. Fine.

Chairman DOMENICI. Senator Chiles?

CBO DEFICIT REESTIMATES

Senator CHILES. Dr. Rivlin, as I understand, with your new estimates now, based on the technical changes and the new economic forecasts that you are making, we are talking about a deficit in 1983 from $119 to $124 billion?

Dr. RIVLIN. I cannot give you an exact number, Senator. What I have said in the statement is that we expect——

Senator CHILES. Well, I am not asking for an exact number. I am asking for the range. I thought you said in your statement that you were adding $3 to $8 billion.

Dr. RIVLIN. In 1982. Are you talking about 1982 now?

Senator CHILES. All right. Let us start in 1982.

Dr. RIVLIN. We can be much more precise about 1982; it is almost over.

Senator CHILES. So, in 1982, what do you think it is going to be?

Dr. RIVLIN. The resolution shows $106 billion. The weakening of revenues will add something to that. My best guess would be in the range of $110 to $112 billion.

Senator CHILES. All right, $110 to $112 billion. Now, if we add $25 to $35 billion to the 1983 deficit, where does that put us in the 1983 range then?

Dr. RIVLIN. The question is what do you add it to, clearly.

Senator CHILES. Well, what was your earlier estimate of the deficit, assuming we enacted everything in the first budget resolution? Let us try adding it to that one.

Dr. RIVLIN. Let me get to that. The budget resolution says $104 billion, as you know; that is the estimate. We did have some technical differences with the administration amounting to about $12 billion, which are reflected in the budget resolution estimates. Those reflect differences principally over offshore oil receipts, defense expenditures, and some revenue differences. They are technical, not

98-044 O - 82 -- 2

economic, differences between our estimators and the administration's which are reflected in the conference report. That is about $12 billion for 1983.

We have not reexamined those in this report, which is why I am being so vague. I want to alert you to the fact that we have not seen the administration's midsession review. We would normally examine that and see whether we still think we are about on track with the technical estimates. We have not had an opportunity to do that.

Our differences might be larger; they might be smaller. I really do not know. But if you assume that they are about the same, then you would be adding the $25 to $35 billion to a number of about $116 billion.

Senator CHILES. To a number of about $115 billion?

Dr. RIVLIN. $116 billion.

Senator CHILES. $116 billion. So, you are saying $116 to $125 to $135 billion?

Dr. RIVLIN. Yes.

Senator CHILES. So, it is $141 to $151 billion?

Dr. RIVLIN. That is right, but I am not saying that that is a right number because we do not know——

Senator CHILES. None of us know whether it is the right number. I want to find out what your number is.

Dr. RIVLIN. Right.

Senator CHILES. So, you are now projecting a deficit in 1983 of $141 to $151 billion. Now, what about 1984?

Dr. RIVLIN. Let me say, Senator, I am not projecting that. That is what you would get if you added this to the old numbers, and we are not sure what the new numbers would be.

Senator CHILES. All right. What is the projection for 1984 then? Is that $145 to $150 billion?

Dr. RIVLIN. Roughly. Our technical estimates for that year were slightly larger—in the range of $21 billion to be added to the $84 billion in the resolution, which would get you to the range of $145 to $160 billion.

Senator CHILES. All right. And then for 1985, you would have $143 to $158 billion?

Dr. RIVLIN. That is right. So, essentially it would show that the deficit, without further action, would stay in the same range over the 1983-85 period. It would decline as a percent of GNP, but it would stay in roughly the same dollar range.

Senator CHILES. So, under the reestimates now, we are talking about having a deficit that is basically going to stay in the same range of $140 to $150 billion for 1983, 1984, and 1985? And that is if we enact everything in the budget resolution?

Dr. RIVLIN. If the economy performs roughly as we now expect it to and if the technical estimates stay the same.

EFFECTS OF HIGH DEFICITS

Senator CHILES. Well, what are deficits of this number going to do to the economy and to interest rates?

Dr. RIVLIN. Deficits of that magnitude are worrisome and might lead to interest rates that would be somewhat higher than they

would be otherwise. I cannot give you an exact projection, but it would, I think, be reassuring to the financial community and conducive to getting the interest rates down if the Congress in future years were to take further action to reduce the deficits.

EFFECTS OF TIGHT MONEY AND HIGH DEFICITS

Senator CHILES. Chairman Volcker has recently testified that he is going to maintain his current monetary policy and not change the target ranges. What do you think a continuation of tight money combined with deficits in the neighborhood of $150 billion a year for 1983 and 1984 portend for our economy?

Dr. RIVLIN. In the first place, I think you should question the Chairman carefully when he appears tomorrow. It does seem to me in reading his statement for the hearing before the Senate Banking Committee that, although he has not raised the targets, he has indicated for the first time that the Federal Reserve would stay at the top end of the range and might even run over the range. It does seem to indicate some loosening of monetary policy.

Our projection is that, given that monetary policy, interest rates will come down over the next few months sufficient to be consistent with a moderate economic recovery.

Senator CHILES. This is consistent with a moderate economic recovery?

Dr. RIVLIN. Yes; it is. But that is not to say deficits in the future are not important; I think they are. It will take a major effort, given this economic forecast, for the Congress to keep deficits from escalating. It would take further effort either on the tax side or on the spending side to get them coming down, and that would seem to me to be conducive to a more vigorous economic recovery.

Senator CHILES. Well, you just mentioned that you thought that interest rates would be higher than normal given these kinds of deficits. I do not know what "normal" is now, given the kind of interest rates we have had.

Dr. RIVLIN. Nobody does.

Senator CHILES. How can we have much of a recovery if we cannot really get interest rates down to normal?

Dr. RIVLIN. Unless interest rates come down substantially, I do not think we can have a vigorous recovery. That is why the CBO forecast is as weak as it is. We think we will have a recovery, but we do not think that it will be of the vigorous, robust sort that one might have hoped for, and the reason is exactly what you are saying. It is that real interest rates are extraordinarily high. This is clearly inhibiting investment, and it is very worrisome for the sustainability of the recovery.

UNEMPLOYMENT TO DROP DURING RECOVERY

Senator CHILES. How do you see that recovery affecting unemployment? What do you see happening to the unemployment numbers?

Dr. RIVLIN. Given our forecast of moderate recovery, unemployment would come down only very slowly. It would average 8.8 percent for 1983.

Senator CHILES. 8.8 percent for 1983?

Dr. RIVLIN. That is an average for 1983. It would be down a little lower than that by the end of 1983, but still over 8 percent; it would stay very high.

Senator CHILES. Have you done anything about 1984 and 1985?

Dr. RIVLIN. Yes; we have run our projection out that far. The unemployment rate comes down only very slowly because we are assuming moderate growth rates, not really rapid ones. I will give you those numbers.

Senator CHILES. Just tell me, are you projecting higher unemployment than you had previously projected?

Dr. RIVLIN. Slightly; yes. The unemployment rate that we have for calendar year 1984 is 8.2 percent.

Senator CHILES. And you had projected 7.6?

Dr. RIVLIN. And for calendar 1985, it is 7.8 percent, so you can see it comes down very slowly.

Senator CHILES. And you have projected 7.2?

Dr. RIVLIN. In February, we had assumed 7.2 percent for calendar year 1985.

Senator CHILES. I yield.

Chairman DOMENICI. Thank you, Senator Chiles.

Senator Quayle?

HEIGHTS OF DEFICITS WITHOUT TAX BILL

Senator QUAYLE. Thank you very much, Mr. Chairman.

Dr. Rivlin, pursuing the line of questioning of Senator Chiles, I understand the ranges for 1983 and 1984 will amount to around $140 billion in deficits. I wonder if you might comment on what those ranges would be if, in fact, the Congress does not pass the tax bill that was passed by the Senate.

Dr. RIVLIN. They would be very appreciably higher.

Senator QUAYLE. But would you basically add the $95 billion of additional revenues? Would you just add that on in the outyears, being $35 or $40 billion, or would its deficits be even higher because we would be signaling the markets and the people that deficits really do not matter?

I wonder if you might give us an overall assessment on the budgetary deficit if, in fact, a tax revenue bill is not passed by this Congress.

Dr. RIVLIN. I could not give you a number, but I think it could well be worse than the primary revenue effect of the tax bill, just for the reason that you say. If the outyear deficits are seen to be even larger than the ones projected here, failure to pass the tax bill would be an especially bad signal.

Senator QUAYLE. In other words, there is no doubt in your mind that if, in fact, a revenue bill is not passed, there would be a substantial upward pressure on the deficit that would lead to an upward pressure on interest rates, which would tend to minimize the moderate economic recovery that you have stated today.

Is that a fair assessment of what would happen if, in fact, there would not be passage of the tax bill?

Dr. RIVLIN. That is a fair assessment. I think that both the spending cuts and the tax increases contemplated in the first resolution are necessary to hold the deficit even at the levels that we

are projecting here. To ease up on that effort to implement the resolution would clearly make the deficits larger and threaten the recovery very substantially.

ECONOMY NOW BOTTOMED OUT

Senator QUAYLE. Dr. Rivlin, you have talked about a moderate economic recovery. Are we now entering into a period of economic recovery?

Dr. RIVLIN. I certainly hope so. The signals are very mixed. Our forecast assumes what most forecasters are assuming: that we are at the bottom of this recession. It is turning out to be a little flatter bottom than was anticipated. But the forecast assumes that we are at the bottom and that things will turn up in the second half of the year, though not quite as vigorously as had been anticipated.

The statistics are, however, very mixed and very confusing. Some of them would indicate that the recession was over; some would indicate that it was still going on. The signals are just very difficult to interpret. But we think that this is the bottom and it is likely to turn up.

Senator QUAYLE. Basically, you are saying that we are beginning to enter into a period of economic recovery. You cannot anticipate the degree of recovery with any exactness, but from the signals you see and from your analytical point of view, you do believe that we are entering into an economic recovery and we will see a stronger economy in the second half of this year.

Dr. RIVLIN. Absolutely.

RECOVERY TO CONTINUE FOR YEARS

Senator QUAYLE. Can you go beyond the second half of this year and into next year to project the duration of this economic recovery that we are going to experience?

Dr. RIVLIN. We are projecting that it will continue for the next several years at moderate rates. That is, of course, very uncertain. The further out in the future you get, the more uncertain it is. But our present anticipation is that the recovery will continue for the forecast period at moderate rates of growth.

NO TAX BILL DETRIMENT TO RECOVERY

Senator QUAYLE. And if a revenue bill is not passed by the Congress, do you think that this would be a debilitating factor to the economic recovery that we are about to enter?

Dr. RIVLIN. Yes; I think anything that would increase the deficits more than projected would threaten the recovery.

Senator QUAYLE. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Quayle.

Senator Riegle?

Senator RIEGLE. Dr. Rivlin, I am very much concerned about these deficits that you now foresee stretching forward starting with this year but going out to 1983, 1984, and 1985. And those deficits, as you just a moment ago discussed, are in the range, as it now appears, of $140 to $160 billion over the 3-year period of time.

Most people I talk to in the financial community and economists across the country feel that deficits of that size will do great damage to the country in many ways. They will certainly have the effect of keeping interest rates high and will probably put us on a cycle of interest rates at too high a level and will abort recoveries that may start.

So, even if we get an upturn going, it will not be able to last. I am very distressed at those numbers. As a matter of fact, my own judgment is, if anything, they are optimistic. I talk with a lot of people across the country, including a number of other professional economic forecasters who are projecting even higher figures, as you know, in terms of those deficits.

CROWDING OUT

What do you foresee as the Federal borrowing requirements in the third quarter of this year and the fourth quarter of this year? What do you anticipate those are likely to be?

Dr. RIVLIN. They will be very substantial. I can give you a number for the record, but they will certainly be higher than we have seen in the first half of the year.

Senator RIEGLE. On the order of what, $40, $50 billion? Might they be that high on a quarterly basis?

Dr. RIVLIN. Yes.

Senator RIEGLE. Now, we have not had Federal borrowings in a quarter that high before recently, have we? Are these not extremely high figures?

Dr. RIVLIN. In the second half of this year, we are looking at higher than usual rates of borrowing.

Senator RIEGLE. Now, the problem that many people have and that I am concerned about is the crowding-out problem. As small business people try to borrow money or farmers try to borrow money, or corporations or others in the private sector, the Federal Government barges in for these enormous debt financings related to these deficits. I am afraid that will keep the interest rates high, particularly long rates.

We are seeing some softening of short rates because the Fed seems to have loosened somewhat in that area, and I think there is even some flight of money into short-term securities. We have not seen any appreciable drop in long rates, and that is a great concern to me because we are not going to be able to get the whole capital investment cycle and productivity improvement cycle going if we cannot get those long rates down.

Are you not apprehensive about that level of Federal borrowing through the remaining 6 months of this year?

Dr. RIVLIN. Not through the remaining 6 months of this year. I think it gets worrisome in 1983 and beyond, as you expect the economy to pick up more and the competition with private borrowing to be more intense.

BORROWING TO DRIVE INTEREST RATES UP

Senator RIEGLE. People like Henry Kaufman and Wojenaur feel strongly that as we get down to the latter part of this year, these big Treasury borrowings are going to drive interest rates back up.

Dr. RIVLIN. They are more worried than we are.

Senator RIEGLE. What do you think is likely to be the picture on interest rates, say, in the fourth quarter of this year?

Dr. RIVLIN. We see interest rates coming down somewhat in the fourth quarter.

Senator RIEGLE. What would be your estimated range?

Dr. RIVLIN. I cannot give you a quarterly number, but we see the trend as basically down. We do, however, expect that as the economy recovers in 1983, the short-term rates may trend up again.

Senator RIEGLE. Do you see the prime coming as low as, say, 12 percent this year? Is that realistic?

Dr. RIVLIN. I do not have a projection for the prime rate. That would be nice.

Senator RIEGLE. Well, I realize you would like to sidestep that question.

Chairman DOMENICI. She always does.

Senator RIEGLE. But the point is that if we cannot get the prime down to that level, we are not going to see much of a real recovery. And I am just wondering if it is realistic to expect that we might get to that level, or are we talking about a floor on interest rates that is likely to be, say, a prime somewhere above 12 percent?

Dr. RIVLIN. I really do not think we know, Senator. As I indicated in my statement, there is historical precedent in this kind of situation for interest rates to come down very rapidly, and we might see that. It does not seem terribly likely, given other things that are happening, but it is certainly possible.

Senator RIEGLE. When you look at corporate balance sheets today and you look at the liquidity squeeze that is going on, we have got literally thousands and thousands and thousands of companies hanging on by their fingernails right now—all sizes, from big ones right on down to the smallest ones.

I mean, we have companies that are dying for lack of capital. There is a shortage of liquidity, and it is of such crisis proportions that I had the head of a major investment banking entity in my office last evening saying that this is the worst situation that he has seen since the 1930's.

So, I do not see how you can be so sanguine about the fact that we clearly have a cash flow crisis in the private sector. People cannot borrow long; they cannot afford these rates. Yet, somehow miraculously all of this is going to take care of itself. I mean, I do not know what you base that on.

Dr. RIVLIN. I do not see anything miraculous. It is a very difficult situation, but I do think there is hope that, as the economy recovers toward the end of the year, the cash flow position of these corporations will ease.

DOES UNEMPLOYMENT RATE INCLUDE ALL UNEMPLOYED

Senator RIEGLE. Let me ask you one other thing on unemployment. In Michigan, we have had unemployment now above 10 percent for 32 consecutive months. We have about 750,000 people unemployed that we count, but we have another 125,000 to 150,000 that we do not count any more because they have exhausted their unemployment benefits.

When you talk about a possible 8.3 percent unemployment rate next year, which in my view would be much too high, does that take into account people whom we do not put into the statistics any longer simply because they have exhausted their unemployment benefits or they have just given up out of sheer frustration?

Some estimates say that that number could be as high as anywhere from 3 to 5 million people in this country. Are you including them in the 8.3 percent?

Dr. RIVLIN. We are including people who are unemployed and are looking for work, even if they have exhausted their benefits. That is the standard definition used for the unemployment rate. We do not include people who have simply dropped out of the labor force in discouragement and are no longer looking. They would be in addition to those calculated in the unemployment rate projection.

Senator RIEGLE. So, that 8.3 then may not be an accurate number. If we talk about the number of people in the country who cannot find work, who have not found work, who ought to be at work, and who would prefer to be at work, that number could easily be 10, 11, 12 percent, then, once you add in the discouraged worker category?

Dr. RIVLIN. If you add in discouraged workers, it would certainly be higher, and the number of discouraged workers, to the extent we can measure them, has risen. It always rises when the unemployment rate rises.

Senator RIEGLE. Well, I think the time has come for us to do something about it, and I am concerned because I do not think that is high on the list of priorities of the administration or of the Congress. But I think it is time that we put people back to work.

Chairman DOMENICI. How, Senator? Do you have any ideas?

Senator RIEGLE. Yes; I have a lot of ideas, Mr. Chairman. One of the first ideas is to get these interest rates down and get the deficits down.

Chairman DOMENICI. How?

Senator RIEGLE. Well, the best way, I would think, would be to cut those bloated increases in the defense budget that virtually every business leader in this country today is suggesting be reduced. In fact, even defense contractors in this country will say privately that they are appalled at the rate of increase and the waste in the defense budget.

As you know, this committee—and the chairman was part of the effort—came in here and basically had a separate standard for defense spending to lard that part of the budget with extra billions of dollars, and that is part of this deficit problem here. That is just the hard fact, and anybody who analyzes it knows it.

The only people who will not face that are a handful of people in the inner circle in the White House who are hard-line ideologs on this issue. But we are overspending in that area. That is just one of the sacred cows. We are overspending on western water projects; that is another sacred cow. There are a number of others in the budget, as the chairman knows.

If we want to get these deficits down as I think we need to, we are going to have to take the ax to the sacred cows, and I am ready to do it.

Chairman DOMENICI. You are right. You just do not name the sacred cows; you name your sacred cows.

Senator BIDEN. All of his are gone.

Chairman DOMENICI. All of his——

Senator BIDEN. His sacred cows have been slain at the altar of supply-side.

Chairman DOMENICI. That is right; they are gone. [Laughter.]

Senator SYMMS. Joe, we have been milking those sacred cows so long, there are no sacred cows left.

Chairman DOMENICI. I think we are going to go to Senator Metzenbaum because he was here and waiting, rather than rotating, if that is all right with Senator Kasten. We will try to stay with the 5 minutes, so you will all get a turn, I am sure.

Senator Metzenbaum.

Senator METZENBAUM. Thank you, Mr. Chairman. I would like to say to my good friend from Michigan that this table started to literally shake when you mentioned western water projects. Please do not do that any more.

Chairman DOMENICI. We would balance the budget if we got rid of all western water projects.

Senator RIEGLE. It would help.

Chairman DOMENICI. We will balance it by the year 4000 if we get rid of all of them. [Laughter.]

ARE INTEREST RATES AFFECTED AROUND ELECTION TIMES

Senator METZENBAUM. Dr. Rivlin, you gave us a number of projections and comments as to what is going to happen, and then you added one statement that you expected that rates would be going down toward the end of the year and will probably go up afterward.

Yet, I did not hear anything in the economic basis as to why that occurs. My real question is why do interest rates always seem to go down around election time and then go up afterward—Democrats or Republicans? [Laughter.]

Dr. RIVLIN. I am not sure that is a historical fact, Senator, but the reasons that we expect the interest rates to go down really have nothing to do with elections. They have to do with the weakness of the economy and with the mystery of why rates have been so high so long when inflation is coming down.

Senator METZENBAUM. Well, the economy is certainly weak now and they are not down, although they are down a fraction; they are down a point.

Dr. RIVLIN. They came down a little bit yesterday, which is encouraging.

REEVALUATE WAYS OF FIGHTING INFLATION

Senator METZENBAUM. About a half a point yesterday.

Let me ask another question. Many years ago, you sat a table over there when the room was set up differently, and I asked you at that time whether or not high interest rates were not, in and of themselves, inflationary because they add to the cost of everything that is purchased. And you said, "Yes. As a matter of fact, on a

temporary basis that is so. But long range wise, high interest rates are anti-inflationary."

Now, I think that when you have economic facts where the demand exceeds the supply, then in the past we have always used high interest rates as an anti-inflationary measure. But the economic factors are totally different now. The supply far exceeds the demand. Yet, we are still maintaining high interest rates as a means of fighting inflation.

My question to you is, you promised me at that time that they were going to come down eventually. They have not come down; they have continued to go up. My question is, is it not time for this Government or this Federal Reserve Board to reevaluate the entire question of high interest rates or tight money being a way of fighting inflation?

Dr. RIVLIN. First, I would suggest you try that one on Chairman Volcker tomorrow.

Senator METZENBAUM. I intend to. I thought I would lay a foundation. When I got your affirmative, then I would be able to point that out to him. [Laughter.]

Dr. RIVLIN. If I said some time ago that the high interest rates might be conducive to bringing the inflation down, I think clearly the inflation has come down. The question is whether——

Senator METZENBAUM. I want to point out that since you said that, inflation has gone up because that was back in the days of Carter.

Dr. RIVLIN. Inflation has gone up?

Senator METZENBAUM. That was in the days of Carter, and inflation was I do not even think as high as it went in the latter period of the Carter administration. You said they would be coming down, and they have not come down realistically. They came down more recently because energy prices came down. There was not any housing, so you eliminated that. But if you eliminated those factors, you did not have much left from the standpoint of inflation coming down. Now, it is going back up.

Dr. RIVLIN. Inflation has come down substantially in the last 2 years because of a combination of factors. On the one hand, there has been a reversal of some of the things that had been upward shocks; there has been a great deal of help from the oil price side. But also the recession, in large part brought on by high interest rates, has itself contributed to the lowering of the inflation. Now, that may be a very painful way to do it, but it has worked.

The point is not that anybody is in favor of high interest rates, per se, not even Chairman Volcker. But winding down the money supply gradually over time is a way of getting inflation down. It has very high costs, however.

Senator METZENBAUM. Well, I do not follow how high interest rates help fight inflation, because every 1-percent increase in unemployment increases the deficit $25 billion in 1983, $40 billion in 1984, and $42 billion in 1985. Every 1-percent increase in interest rates increases the deficit very substantially.

As a matter of fact, every point increase in inflation decreases the deficit, actually, because revenues then outpace outlays.

So, my question really is, Is it not time to take a look and reevaluate and change—literally change—not reevaluate, but change this

tight money policy, and would it not serve our Nation's economic policies and would it not also help to balance the budget?

Dr. RIVLIN. Within limits, I think that one could argue for an easier monetary policy to bring down interest rates more rapidly and to stimulate growth. There is a risk, however, that this will reescalate inflation and give you trouble in the long run.

In any case, the main problem of this committee is really not to set monetary policy, but, given monetary policy, to set budgetary policy. Clearly, getting the deficits down takes some of the pressure off of monetary policy and enables you to get the interest rates down, too.

Senator METZENBAUM. Well, I agree that it is not our responsibility to set monetary policy but to set budgetary policy. But it seems to me we also sit here as Members of the U.S. Senate, and I think in that respect we do have a responsibility to put some pressure on the present head of the Federal Reserve Board, or if not him then on some successor that perhaps the President ought to put in his place.

I think my time is expired.

Chairman DOMENICI. The light turned red when you said that.

Senator METZENBAUM. Yes.

Chairman DOMENICI. Senator Kasten?

Senator KASTEN. Thank you, Mr. Chairman.

TAX BILL MISDIRECTED

I would like to switch the conversation just a little bit. The reason we are in trouble today and the reason your deficit projections are different is because the recession is deeper and longer than we anticipated. The recovery is slower——

Dr. RIVLIN. That is right.

Senator KASTEN [continuing]. And interest rates are not coming down as fast as we thought they would.

Now, we just passed a tax bill. The tax increases were directed primarily toward businesses instead of individuals, in an effort to protect the economic recovery program and theoretically work toward a balanced budget. The kinds of taxes that were passed are precisely the kinds of taxes that you have testified against, would reward investment, savings, and the job-producing kinds of activities. This year's tax bill is completely different.

The direction of this tax bill—the $98 billion—is somewhat off base. If we had to raise taxes, wouldn't we be better off raising an overall energy tax or some other tax rather than a tax on savings and investment?

Dr. RIVLIN. I do not want to take a position on a particular tax bill, especially versus an unknown one. But it would seem that the judgment of the Congress was that you had perhaps gone a little too far in the tax act last year and that it was time to redress slightly, especially in view of the urgent need for revenue to close the deficit gap.

DIRECTED AT SAVINGS AND INVESTMENT

Senator KASTEN. Well, that was the judgment of the Congress. There are a few of us that believe that judgment might have been

faulty. A year ago, you supported certain kinds of tax cuts, such as accelerated depreciation and different rewards for savings and investment.

Now, Congress has backed away from that somewhat. In the process of making that shift, what we have done, in fact, is lengthened the recession and prolonged the recovery. I assume the numbers are still right; that a 1-percent increase in unemployment increases the deficit by $22 billion. A 1-percent decrease in GNP increases the deficit by approximately $60 billion.

Are we not going in the wrong direction if we continue to tax these kinds of activities?

Dr. RIVLIN. I do not see anything in this tax bill that threatens the recovery, Senator. One might argue about particular provisions, but the net stimulus to investment provided over the next 2 years if this bill becomes law would still be very, very considerable.

WHAT THEN TO HELP SPEED RECOVERY

Senator KASTEN. What can we be doing, then, in order to attack the deficits at their source? What more can we be doing?

We have concentrated our discussion this morning on balancing the budget, on cutting spending, and indirectly on increasing taxes. If we attack the deficits at their source, at the recession, what should we be doing in order to pop us out of this recession?

Dr. RIVLIN. Unfortunately, I am not sure that there is a great deal that you can do through the budget to insure that this recovery happens quickly in the short term. Whether or not that will happen depends on the results of actions already taken. It depends in part on monetary policy, but it also depends on how consumers react to the tax cut they already have and how investors eventually react to the stimulus of tax incentives plus a recovering economy. I do not think there is much you can do in the next few months except hope for the best.

I think you do, however, have to think about the deficits in the out-years, and consider whether another round of spending cuts or tax increases or some combination of them designed to be stimulative to the economy and to investment and to picking up revenue would not be helpful in bringing the deficits down in the future and in insuring that this recovery is sustained.

CONSUMER-LED RECOVERY

Senator KASTEN. You suggested in your statement that when we do come out of the recession, it will be a consumer-led recovery. With this month's 7.4 percent cost-of-living increase, the full 10-percent tax cut, there theoretically are more dollars available for consumers.

At this early date do you know where those dollars are going? I am told that savings are increasing. In other words, people are putting money away because of uncertainty. Do you have any indications of this?

Dr. RIVLIN. No; That is part of the big uncertainty. We do expect saving to increase, but there is uncertainty about how much. But, clearly, one thing that people do when they get additional tax money, particularly in an uncertain period, is save it.

Of course, part of the original argument for this tax cut was not that it would go so much to consumption but that it would increase saving. Clearly, that is partly right, and we expect that as the recovery proceeds there will be increases, particularly in purchases of durable goods. But that is not clear from the statistics yet.

PRIME RATE PREDICTION

Senator KASTEN. Yesterday, two major banks reduced their prime rates from 16 to 15.5 percent. There seems to be a difference of opinion among economists as to what this indicates for the future. This could affect the entire banking system. This could be the beginning of a long-term trend, or just kind of a blip.

What is your opinion as to what this change in the prime rate indicates?

Dr. RIVLIN. I would not be brave enough to predict the prime rate in the near term. I certainly hope it indicates that these rates are on the way down.

Senator KASTEN. I think we all hope that. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Kasten, thank you very much. I am going to go to the Energy and Natural Resources Committee. Senator Quayle, if you will please chair. If you cannot stay until we are finished, somebody can come and get me and I will leave the other hearing and come here. Thank you very much.

Senator Biden?

[Whereupon, Senator Quayle assumed the chair.]

Senator BIDEN. Thank you, Mr. Chairman.

CBO DEFICIT FIGURES INCLUDE EXPECTED UPTURN

Dr. Rivlin, I want to make sure I understand the basic premise upon which we are proceeding this morning, and that is that, as it relates to deficits, your analysis or CBO's analysis of deficits exceeding $140 billion in the next 3 years—and as high as $160 billion in and any one of those three, but exceeding $140 billion—already has factored into it the economic recovery that you also foresee; correct?

Dr. RIVLIN. That is correct. Those particular numbers are not my numbers.

Senator BIDEN. Well, not yours; there is a little elf who computes them, or whoever.

Dr. RIVLIN. It is important to understand that we do not yet have a new fix on the technical reestimates for the budget numbers for those outyears. But adding the current economic picture to the old numbers does leave you with deficits in the range of $140 to $160 billion over the next 3 years—deficits that are not rising, but are not declining either. What the Congress would seem to have done is to arrest the increase which, as the chairman said, would otherwise have taken place. But there is danger that it will not go down.

EFFECT OF BALANCED BUDGET AMENDMENT ON RECOVERY

Senator BIDEN. Now, the Congress is at this moment in the process of debating a constitutional amendment to balance the budget.

If that passes and if each of the State legislatures which petitioned us to pass such an amendment were to meet by the beginning of next year, and within 6 months, which is absolutely possible, we have a constitutional amendment requiring a balanced budget, that means that for the 1985 budget we would have to be in balance.

Can you see any reasonable prospect—let me put it another way. What would be the effect of requiring a balanced budget on any recovery you foresee if the budget were required to be in balance in fiscal year 1985?

Dr. RIVLIN. I think you have put your finger on a very significant problem with the constitutional amendment. It is not that it would be so difficult to live with if you started with a balanced budget and were keeping the budget on the track. But if you start from a very large deficit situation, which is what you are postulating, it could be very difficult indeed.

If the amendment were to come into force for fiscal 1985, then the numbers we have been talking about would indicate that you would somehow have to find, either on the tax side or on the spending side, around $140 billion to close that gap. Reducing spending or raising taxes by that amount would clearly be a drastic action that would have a strong effect on the economy, and would probably throw it into another recession.

You do have "outs" in the constitutional amendment that would allow you, with a supermajority, to override and not to have a balanced budget in the first year.

Senator BIDEN. Although it is not within your province, can you imagine how we would be viewed—and we are already viewed with skepticism anyway—how we would be viewed in the first budget after having passed a constitutional amendment—the first action we would take would be to use the supermajority to say, "We really did not mean it."

Maybe if we get a promise from the State legislatures that they will not ratify it for 7 years, it might make some sense. [Laughter.]

I realize I am being a little facetious, but I hope everyone understands that there is a better chance of this amendment passing and being enshrined in the Constitution in 6 months than there is within 7 years. That is the prospect, and anybody who thinks that will not cause economic chaos or political chaos in this country deserves to be here. [Laughter.]

TYPE OF BUDGET NEEDED TO KEEP RECOVERY WORKING

I realize my time is almost up, but everybody exceeded their time a little bit. Let me ask another question. I am a little confused. In this committee, we talk about a congressional action, the congressional budget, and the congressional tax package. I mean, everybody knows that it is not the congressional tax package. Everybody knows that Bob Dole and a lot of Republicans wanted to do something about the Reagan economic recovery act, but they said downtown, "If you do it, you are dead; we are not going to play." So, they had to come up with another proposal.

Everybody knows that the Congress did not send up this deficit; the administration sent it up. And we keep talking about the Congress. We are not all that good, but what I do not understand is

how we factor out an administration. I understand the desire to want to do that, but I do not understand how that can be.

So, when we talk about the budget, what kind of Presidential budget has to be submitted next year to keep the recovery you see going and to keep the deficit from growing?

Dr. RIVLIN. Unfortunately, I think the budget is a joint action of the administration and the Congress, and solving the prospective problems is going to take everybody working together. I believe that the threats of deficits that do not decline over the next several years are serious and that bringing the budget deficit down is going to take strong action on both sides of the budget, probably including moderation of the defense spending increase, significant action on the entitlements, and further tax changes. Those kinds of drastic actions take cooperation between the administration and the Congress.

Senator BIDEN. But all of those things are needed, though?

Dr. RIVLIN. You need all of those things to get the budget deficit coming down.

Senator BIDEN. Well, if the figures we have been discussing this morning are correct, deficits are not any longer trending down. And most of all, the budget cuts and tax increases have managed so far only to freeze the deficits at inordinately high levels.

I, for one, really do not see how, short of drastic action from a budgetary side, we are going to be able to do anything to make much of an impact.

I should just note in closing, Mr. Chairman, that it is curious that the Senator from Wisconsin, Senator Kasten, and I feel the same way about the tax cut program. I mean, we have sat here ad nauseum for a year-and-a-half hearing about supply side and ginning up business. Now, we are counting on consumers to get us out of this. Now, we are counting on demand side.

If this President does not understand and my colleagues in this Congress do not understand that it is time for a fundamental change in direction, we are going to hell in a hand basket as fast as the American people believe we are, and they believe we are. It is about time that we listened to what they are saying. They think we are in depression and not moving very fast in any other direction.

So, thank you, Doctor. Obviously, you are welcome to comment on that. Knowing you, I suspect you will not want to.

Dr. RIVLIN. You are right. [Laughter.]

Senator BIDEN. So, let me stop. Go ahead; fool me and comment on it.

Dr. RIVLIN. No, thank you.

Senator QUAYLE. The red light has been on for 5 minutes.

Senator BIDEN. Yes, I understand that, and I appreciate the chairman's indulgence. Thank you.

Senator QUAYLE. It is always a pleasure to hear you.

Senator Riegle, do you have any further questions?

BUDGET SUMMIT

Senator RIEGLE. I have suggested several times that because of the urgency of getting down the deficit and structuring a bipartisan agreement as to how the deficit in spending could be further

reduced in a number of areas, and particularly in the sacred cow areas that have not yet been cut, the only way we could accomplish this would be for the President himself to take the lead in initiating a new kind of budget summit effort, and would invite the Members of the Congress and the leaders of both parties—Tip O'Neill and Bob Michel and Howard Baker and Robert Byrd, and perhaps even others—along with Paul Volcker and members of the Fed Board to meet somewhere like Camp David for a period of maybe 2 or 3 weeks, if it takes that long, to structure a breakthrough on these deficits so that we are not locking ourselves on a path that keeps us out there in the range of $140 to $160 billion in deficits over the next 3 years.

The concern I have is that, first of all, the indications from the White House are that they are standing pat; they do not believe there is a need for a midcourse correction. They do not want to make a midcourse correction, and therefore are not interested in this idea or any idea like this.

My concern is this, Dr. Rivlin, and that is that we have got something close to 40 working days left in this session of Congress, if one takes out the weekends and the recess periods that are scheduled over Labor Day, and so forth. The window is closing on this session, and actually once the Congress shuts down, it will not be really until the first part of the second quarter of next year that the new Congress is back, fully organized under the committee structure, up and running and able to act in the normal course of events on complex issues.

Barring an emergency in the meantime, the Congress, in effect, will not be able to respond in this kind of sweeping way for a period of longer than 6 months once this session comes to a conclusion.

I am greatly concerned that the administration may not understand the importance of hitting this window before it closes to make these adjustments in the fiscal plan and, in turn, get a response on the monetary side where interest rates, in fact, would come down, they would come down measurably and they would stay down. And we would see improvements not only in short-term interest rates but also in long-term rates, which are the key to a basic kind of sustained economic recovery.

If such a meeting were held and you were invited to participate, would you be willing to go to such a meeting and help us forge that kind of a bipartisan change in the policy mix that could get us on a different track—a track toward balancing the budget at some future date, rather than a pleateu of deficits in the $150 to $160 billion range?

Dr. RIVLIN. CBO stands ready to help in any way we can and under any structure. We would be happy to participate.

CBO NOT CONTACTED ON SUMMIT QUESTION

Senator RIEGLE. Have you been approached on that basis by anybody? Has there been any hint or suggestion from Ed Meese or Chief of Staff Baker at the White House or anybody else that there is even the slightest interest in wanting to maybe sit down while

there still is time this year to try to structure some change in this fiscal and monetary policy mix area?

Dr. RIVLIN. No, I have not.

Senator RIEGLE. But you would be willing to respond if asked to participate in that kind of an effort?

Dr. RIVLIN. It is hard to accept an invitation that has not been issued, but we would certainly try to be helpful.

Senator RIEGLE. Thank you, Mr. Chairman.

Senator QUAYLE. Senator Johnston and Senator Andrews, we have completed a first round of questions; Senator Riegle had a second round. I would ask Senator Johnston if he might like to question.

CAN FED REDUCE INTEREST RATES IF DESIRED

Senator JOHNSTON. Thank you, Mr. Chairman.

I am sorry, Ms. Rivlin, that I was not here for your testimony. My staff tells me that you have come up with a shocking conclusion that the 1983 deficit will be $140 to $150 billion, which is even higher than I had thought. But it is not surprising that we are surprised because we seem to be surprised every time we come back at the growing deficits and consistent failure to meet the mark in terms of projections.

Now, my question to you is, Is there any doubt at all that short-term interest rates could be brought down by the Fed if they took actions available to them?

Dr. RIVLIN. There is certainly some monetary policy that would bring short-term interest rates down, at least temporarily. The question is would it be worth it.

Senator JOHNSTON. All right. What are those actions which could be taken which would bring interest rates down?

Dr. RIVLIN. It is actually not obvious that interest rates would come down if you increased the money supply rapidly, but I think they would if the increases were more moderate. Let me remind you, however, that I run the Congressional Budget Office, not the Federal Reserve.

Senator JOHNSTON. I understand, but you are also an economist and you are well aware of what goes on in this economy.

The Fed can also enter directly into the markets in bidding on the short-term Treasury bills and other Federal securities, can they not?

Dr. RIVLIN. Yes.

FED CAN BRING INTEREST RATES DOWN

Senator JOHNSTON. So, there is no doubt at all that they can bring interest rates down on a short-term basis, is there?

Dr. RIVLIN. I think they have the power to do that, but it might take large increases in the money supply and possible threats of increased inflation in the future.

Senator JOHNSTON. All right. Now, I understand the problem of such actions on inflation—and we all share the concern with inflation. But what is the percentage of factory utilization at the present time?

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Dr. RIVLIN. It is low. By the Federal Reserve index, I think it is around 70 percent.

Senator JOHNSTON. Actually, it is less than 70 percent, is it not?

Dr. RIVLIN. Yes; it is just under 70 percent.

Senator JOHNSTON. And that is lower than it has been——

Dr. RIVLIN. In a long time.

Senator JOHNSTON. At least since the recession of 1975, and perhaps lower than the 1975 recession.

Dr. RIVLIN. Right.

MONEY SUPPLY CAN REIGNITE RECESSION

Senator JOHNSTON. Now, is there really any real danger of igniting inflation by increasing the money supply when you have factory utilization down below 70 percent—at very low levels?

Dr. RIVLIN. Yes; I think there is. We do not know how much the underlying rate of inflation has come down. Much of the apparent decrease of the last few months has been due to factors like energy. It is likely that the underlying inflation rate has come down from somewhere in the 8-percent range to somewhere in the 6-percent range. But we are not sure that it will stay there.

It is quite possible that rapid increases in the money supply, and indeed very rapid growth, could bring more inflation. It is a very difficult situation.

Senator JOHNSTON. Well, if you were making policy, would you not say that a prudent increase in the money supply—the taking of an action which would bring down these short-term interests rates, which are artificially high—I mean, the real interest rates are at historic levels without any precedent at all and without what most economists say is any reason.

Would you not say that it would be more prudent to increase that money supply at the present time with factory utilization down as low as it is?

Dr. RIVLIN. I am not sure what I would do. There are risks on both sides to be weighed. Certainly, a rapid increase in the money supply might well even give you higher long-term rates. It might scare people into believing that inflation was not coming down, and it might have an adverse effect on the long-term markets. That has to be weighed.

Senator JOHNSTON. These long-term markets certainly do not indicate that people have a feeling that rates are coming down.

Dr. RIVLIN. No, they do not, but you could make it worse. It is really a very difficult situation in which to make monetary policy, and I am glad I do not have to do it.

ADMINISTRATION AND FED TOGETHER ON TIGHT POLICY

Senator JOHNSTON. Well, it is clear that the administration and the Fed are together on monetary policy now, is that not correct?

Dr. RIVLIN. There have been some differences, as you know, between the administration and the Fed on the conduct of monetary policy—exactly how you carry it out. But in general, both the administration and the Federal Reserve have favored a steady winding down of the money supply.

Senator JOHNSTON. Well, actually, I am not aware of any differences between the administration and the Fed. I am aware of an occasional statement in the press about some disagreements, but when the comments came in 2 or 3 days later, we found they were in agreement all along.

It just seems to me very clear that when you have an artificially inflated interest rate and real interest rates at historically high levels, it is prudent to take the risk of increasing the money supply in the face of this level of factory utilization. It just seems to me very clear that that is so.

Thank you, Mr. Chairman.

Senator QUAYLE. Thank you.

Dr. Rivlin, I also am going to have to go. I am going to turn it over to Senator Andrews to sort of wrap this up. I would just like to say my thanks for your participation; I think it is particularly instructive.

CONGRESS MUST HOLD THE DEFICIT LINE

One, your testimony would appear to have a hold, at least, on the deficits. If, in fact, the first budget resolution was not enacted or, in fact, if this revenue bill is not enacted, the deficits, though too large, would be much larger, and it would have really a negative effect on the moderate economic recovery that we are apparently entering, according to your testimony and others. It signals that we are entering into that period, and the strength and the viability of that will be predicated on a number of things, not the least of which what this Congress will be willing to do in the closing months of this session.

So, with that, I turn it over to the Senator from North Dakota.

[Whereupon, Senator Andrews assumed the chair.]

Senator ANDREWS. Thank you, Mr. Chairman. I am sure Dr. Rivlin is thrilled with that prospect. It is good to see you back.

You know, we have been sending smoke signals for far too long on this whole budget process. I think the American public is just totally fed up with the Members of Congress who say we have got to get Paul Volcker's resignation and that will clear the thing up, or even the few who say we ought to get Alice Rivlin's resignation and that will clear the thing up.

Nobody has any solutions, but they sure as heck have got a lot of ideas about what is wrong. You have given us more accurate figures than anybody else who has been before this committee over the year-and-a-half that I have served on it, and I think that is certainly to your credit. If the American public wants anything, they would like to have facts they can adequately base their decisions on.

NO CORRELATION BETWEEN DEFICITS AND INTEREST RATES

Is there any exact numerical correlation between the budget deficits that we are trying to attack and today's interest rates?

Dr. RIVLIN. There is no exact numerical correlation, no. But I think there is strong evidence that, if the deficits are growing in a recovery period, you put upward pressure on interest rates.

Senator ANDREWS. In other words, if we can, through tax adjustment, spending adjustment and a host of other things, bring down outyear deficits, you would think that the interest rates would tend to trend downward as those outyear deficits come down?

Dr. RIVLIN. Exactly.

Senator ANDREWS. Even though you cannot put a precise numerical correlation to it?

Dr. RIVLIN. That is right.

Senator ANDREWS. If we find that the $750 billion tax cut last year was a couple of hundred billion too high and if we reduced it by that amount over the next 5 years, maybe interest rates would be 4 percent lower than they are today? You cannot tell precisely, but is there a chance?

Dr. RIVLIN. You cannot tell precisely, but it seems likely to help.

Senator ANDREWS. My colleague from Louisiana 1 minute ago was talking to you about the tight monetary policy of the Federal Reserve, and you quite candidly and quite accurately said you are glad you are not over there making the decisions.

But what should the Federal Reserve do that would help in bringing down interest rates today that would not exacerbate problems in the economy later on?

Dr. RIVLIN. I think they have done a lot in the last couple of weeks, and probably as much as they can do. Chairman Volcker has said that they would not bring down their monetary targets next year as they had expected to do; that they would leave them at the current levels; that they would expect to be at the top end of the targets and maybe even go over the top for a while. That is probably about as much as he can say.

Senator ANDREWS. Are the activities of Paul Volcker so far about what we need to accomplish the goals that we all realize are so necessary for this country?

Dr. RIVLIN. I really do not want to take a position on the specific monetary policy. As I said, it is fortunately not my job. But based on the indications in the chairman's recent statements, I do think that the Federal Reserve realizes that part of the problem may have been an unusual increase in the demand for money which has put upward pressure on interest rates, and that the Fed is prepared to accommodate that.

Senator ANDREWS. Hopefully, somebody is going to do something about it fairly soon. Hopefully, a whole combination of things will react in the right way. In the 1960's when I was a relatively junior Member of Congress, the thing that was appalling to me was to sit in my House office building and look over at the Library of Congress and see the smoke rising from parts of Washington that were burning because 8 or 9 percent of this Nation's people figured that they were being dumped on by the Government and by others.

Dr. RIVLIN. I remember.

Senator ANDREWS. And if we think those civil rights riots were tough in the 1960's, wait until you get another year or two and the average American begins to realize that he cannot borrow money long term to buy a home, to buy a small business or to buy a small farm. That is a wrenching change in 200 years of American expectations, and something simply has to be done. A number of things have to be done, obviously, to bring these interest rates down.

Do you have any suggestions as to what can be done by others or by this committee that we have not done to get those long-term interest rates down?

Dr. RIVLIN. As I said, I think the lever that you control is the outyear deficit. Getting those deficits down will require another look at the whole budget, not exempting defense spending increases, not exempting entitlement programs, including social security, and not exempting the tax side. You will have to look at the whole thing again.

MUST REDUCE ENTITLEMENT PROGRAMS

Senator ANDREWS. In other words, you feel that, specifically, we have to take a look and do something about entitlement programs in order to properly address the high interest rate problem that is today affecting the country?

Dr. RIVLIN. I think to get deficits down further, you must not exempt the entitlement programs because they are so big.

Senator ANDREWS. We cannot do it with regular appropriations and defense appropriations and juggling the tax figures?

Dr. RIVLIN. No; you are going to have to include the entitlement programs because they are a large part of the budget.

Senator ANDREWS. I like a witness that testifies along the line that I have been trying to take for quite a long time.

PERMANENT ECONOMIC DISLOCATIONS POSSIBLE

When we come out of this recession, Dr. Rivlin, are there segments of the economy that have been depressed for so long that they are just going to be unable to adequately recover? Are we running that risk the longer we let the recession drag on?

Dr. RIVLIN. The longer the recession drags on, the greater is the risk of permanent dislocations. I think the risk is particularly hard for people. People who have been out of work for a long time have a hard time getting back into the mainstream. The risk is also present for industries.

The automobile industry, for example, is suffering not only from recession but also from basic structural changes—increases in the price of fuel and greater competition from abroad. Those problems are exacerbated by recession.

Senator ANDREWS. Well, I appreciate very much your statement. Senator Exon has arrived. It is always a pleasure to have you before this Committee, Dr. Rivlin.

Dr. RIVLIN. Thank you, Senator.

Senator ANDREWS. It was good to work with you on the House side and it is even more pleasant to work with you on the Senate side. You know, as a farm kid, I deal in definites, and I am getting so darned sick and tired of the headline hunters we see in both parties. I think the crisis is tough enough so that it is long past overdue that we start talking about definitive things to do instead of talking about the problem.

I do not think it is enough to say that interest rates were 21 percent under Carter and "Hooray, hooray, look at what we have done." I think we ought to be appalled at what they are today and

realize that we have got to do a whale of a lot more than we have done.

I appreciate your candor, and even more so your accurate estimates as we have seen them develop over the months.

Dr. RIVLIN. Thank you.

Senator ANDREWS. Senator Exon?

Senator EXON. Mr. Chairman, thank you very much.

I want to welcome you along with my colleagues, Dr. Rivlin. I want to echo the words of my friend from North Dakota. We appreciate very much your candor and your forthrightness, and while you, like other economists or would-be economists, such as myself, are not always right, we have to try and deal with facts as best we can.

CBO DEFICIT PROJECTIONS

I understand that you have testified this morning that the 1982 deficit will be, as you presently project, $100 to $112 billion; 1983, $141 to $151 billion; $145 to $150 billion in 1984, and $143 to $158 billion in 1985. Do I understand correctly?

Dr. RIVLIN. Yes; actually, I testified that our present reading of the economy would increase the deficits by about $25 to $35 billion over what we had previously been expecting for 1983, and by corresponding larger amounts for 1984 and 1985. It is somewhat uncertain what you add those numbers to because we have not done a new technical reestimate of the budget. The numbers you gave assume that they are added to the first resolution deficits with the CBO reestimates as of the last round.

Senator EXON. Well, it seems to me, Dr. Rivlin, that at least so far as 1982, you must be somewhere in the ballpark because I think the $110 to $112 to $114 billion range was stated by the Secretary of the Treasury over the weekend on a national television appearance.

Dr. RIVLIN. There is, of course, less doubt about 1982 than about the future.

BALANCED BUDGET AMENDMENT

Senator EXON. I just returned—and I apologize for being late—from a meeting at the White House with the President regarding those of us who are cosponsoring a balanced budget amendment. It looks like we have got a long, long, long way to go.

As we go on down this road and if a balanced budget amendment is passed by the Congress and if it is ratified by a sufficient number of the States, it seems to me that we had better start working on that now because if the figures turn out to be accurate that you have given us and what seems to be the general trend of the economy, we are getting more unbalanced rather than more balanced as we progress into the outyears. Would you generally agree with that?

Dr. RIVLIN. Yes; I think a main point in considering the balanced budget amendment is that, if it is enacted quickly, you do have a long way to go. The problems of transition from where you are now to a balanced budget by 1985 would mean very, very drastic actions on both the spending and the tax sides, which might indeed not

even be possible. So, I think the proponents of the amendment should think carefully about what effective date would be possible and what a transition in the budget process to get from here to there might be.

The numbers also illustrate another problem. We are already three-quarters of the way through 1982 and yet we do not have an exact estimate of the deficit even for 1982. So, there is always this problem that would plague the balanced budget process if the amendment were passed—namely, the forecasts of the deficit even for the current year are not very accurate.

Senator EXON. Well, if the forecasts for the deficit for the current year are not very accurate, then it is probably more likely that the forecasts that you have just indicated, for whatever they mean—the $143 to $158 billion deficit by 1985—if inaccurate, are probably inaccurate on the conservative side. It could go above that?

Dr. RIVLIN. It could, but it could also be better. We would like to stress that the uncertainty is on both sides. We are positing a moderate recovery. The extremes are no recovery at all, which is possible, and a much more rapid recovery, which is also possible but only if interest rates come down very rapidly.

Senator EXON. This probably is not a fair question, but I would just like to maybe get a ball park figure from you. At the most optimistic of evaluations, could you foresee a deficit of less than $100 billion in 1985?

Dr. RIVLIN. Yes; but it would take very rapid growth. That would only happen, I think if you had interest rates coming down very substantially in the next year, and if the economy then just took off and all of the incentives to investment that were built in the last tax cut began operating. I think it would only happen if you had a very vigorous recovery.

Senator EXON. Would not a return to double-digit inflation also make that possible, as well as throwing off all of the other figures?

Dr. RIVLIN. It might, although having indexed the tax system beginning in 1985, you would not get as much impact on the deficit from inflation in that year. You certainly would in the near term.

Senator EXON. We also indexed capital gains, as you know, in the Senate the other day, which would have a rather dramatic effect, I would presume, on revenues.

Dr. RIVLIN. Yes; although that is not a major part of the revenue.

Senator EXON. I assume you do not have these figures with you, Dr. Rivlin, but for the record and for my information, I would like to ask that as soon as possible, you verify the figures that you have just given us and based upon what and over what for the years 1982 through 1985.

In that regard, would it also be possible for you to supply us what your estimate of the total national debt would be at the end of each of those years?

Dr. RIVLIN. Let me see if I understand what you are asking—to verify what the deficit would be on a very rapid growth scenario?

Senator EXON. Well, whatever scenario you used in arriving at the figures that you testified to this morning.

Dr. RIVLIN. That is in my prepared statement. It shows a moderate level of recovery.

Senator EXON. Do you have the national debt figures that would coincide with these figures that you have testified to this morning with regard to the deficits?

Dr. RIVLIN. No, but we could easily supply them.

[The following material was subsequently supplied for the record:]

PUBLIC DEBT SUBJECT TO LIMIT UNDER FIRST CONCURRENT RESOLUTION POLICIES INCLUDING PRELIMINARY CBO ECONOMIC AND TECHNICAL REESTIMATES

[By fiscal year, in billions of dollars]

	1983	1984	1985
Public debt subject to limit	1,309–1,319	1,485–1,510	1,670–1,710

Senator EXON. Thank you very much. I have no further questions at this time, Mr. Chairman.

Senator ANDREWS. Thank you, Dr. Rivlin.

The committee will be in adjournment until tomorrow when we will hear Dr. Volcker.

Dr. RIVLIN. Thank you.

[Whereupon, at 11:18 a.m., the committee was adjourned.]

VIEWS OF THE FEDERAL RESERVE SYSTEM

WEDNESDAY, JULY 28, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:34 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Boschwitz, Andrews, Symms, Grassley, Kasten, Quayle, Gorton, Hollings, Chiles, Biden, Sasser, Hart, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The committee will please come to order.

Chairman Volcker, I really do not know what it means that you and I are the only ones here.

Mr. VOLCKER. It means something good, I assume.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. It is a pleasure to welcome you here today. Your views on fiscal and monetary policy and the effect of policy on the economic outlook are particularly important to the work of this committee.

I might say, getting more and more obvious, that it is important to the whole country. In your testimony last week before the Senate Banking Committee, you said that the Federal Open Market Committee, "Welcomed the determination of the Congress to achieve greater fiscal restraint," and recognized the efforts of the Budget Committees in accomplishing this.

I might say, first, I appreciate these kind remarks. The budget recently adopted by the Congress does include large multiyear savings in spending and increases in revenues, resulting in substantial reductions in projected deficits. Although the actual deficits we will achieve depend in part on the course of the economy. I believe we have taken and will continue to take dramatic steps to lower these so-called structural deficits in each of the next 3 years.

Chairman Volcker, I will be blunt. Last week the Senate passed legislation that reduces the size of future deficits by $118 billion by 1985. In addition, this committee has just reported a reconciliation bill reducing 3-year deficits by an additional $12.5 billion. This is an election year and the Senate has voted to reduce spending by $31 billion in domestic programs that have in the past been untouchable.

The Senate has voted tax increases—no, not tax increases on the average guy like we usually do through changes in margin rates, but reductions in special preferences and tax loopholes that affect the interest of well-financed special-interest groups. This is an election year and the Senate has just voted the largest tax reform bill in history.

Now, I do not believe I am exaggerating when I say to you, Mr Chairman, that this President, acting through the budget process in both Houses, has succeeded in changing the entire frame of reference for policy debate in this body toward fewer Government programs and a sharply reduced growth in Government spending. We have succeeded in reducing marginal rates and tax rates on businesses and have begun to broaden the tax base. These are not changes in numbers. They are changes in approach and values and changes in mood, fundamental changes in the definition of the politically desirable thing to do.

These changes that I describe are fundamental but they are not necessarily irreversible. The Congress has acted single mindedly to reduce the budget deficit because it believes that these actions will bring interest rates into better balance with inflation and that the economy will begin to grow again. If these expectations are not realized in some timeframe, then I think that we stand to lose much of what we have gained in terms of fiscal responsibility during the past 2 years.

I think there is a realism to that.

Mr. Chairman, the first concurrent budget resolution contained a specific provision requesting that in the event that Congress did act to reduce future deficits, the Federal Reserve Open Market Committee would "reevaluate its monetary targets in order to assure that they are fully complimentary to a new and more restrained fiscal policy." I hope in your testimony this morning you will specifically respond to this provision.

In particular, I hope that you will assess for us in your testimony what hope we have for sustained and meaningful reduction in interest rates and, second, given the actions of the Congress this year, whether the Federal Reserve's monetary policy will be sensitive to the need to achieve some economic growth while we are on the road to lower inflation.

As you are well aware, Chairman Volcker, Congress still faces a substantial task in reducing deficits beyond what has been achieved in the first budget resolution. But, clearly, the economic environment in which we find ourselves will, in large measure, determine our success.

As always, it is a pleasure to have you appear before the committee. Once again, I take this opportunity to welcome you.

With that, I will be pleased to yield to my distinguished ranking minority member.

Senator HOLLINGS. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR HOLLINGS

Very briefly, Mr. Chairman, I have been watching the Federal Reserve's concern about high inflation. We have fought the good fight together, trying to bring down these budget deficits. There

have been spending cuts but now we have gone about as far as we can go. We can always pick up $5 or $10 billion more. But the order of the day is to pick up $130 billion or $140 billion. So the $5 and $10 billion cannot do it.

You have an intransigent President with a working majority in both Houses of Congress to continue the revenue hemorrhage. We have failed to put a tourniquet on that, even though we have fought the good fight. We have tried to control the uncontrollable.

Now, I would hope that rather than pushing the economy over the precipice, you understand that all of these principal individuals in the game are not going to give in; your commonsense will prevail and you will not require us to legislate on the Federal Reserve. But that is in the offing. That is imminent if you continue to be adamant, the President continues to be adamant, the facts of life continue to be adamant. We cannot afford to just stupidly go along.

This is totally unnecessary, all these businesses going broke, farms being sold, everyone giving the sing song, meeting on the Capitol steps, and silly nonsense about constitutional amendments to balance the budget and all that folderoll. We have really got to come to grips with the situation.

On your particular level we are going to have to legislate unless you show some awareness of where we are. We are not just worried about inflation. We are worried about the entire economy. Inflation is one thing. I have been on your side in fighting to keep from blaming the Federal Reserve for our economic mess when the Congress would not do its job.

Having not done it, there is no chance. Maybe we can get a special session after the election but that will be too late. If we do not get that, coming in January what you really have is a submission of a budget in late January and early February. We are not going to act again until May or June.

We have 500 businesses going broke every week. That is just not necessary. There has got to be some give on the part of the Federal Reserve at this particular time so that the economy can have a chance. We will still work to complete our job on the budget.

I hope you look at it seriously and we do not just meet with each other, warn each other about inflation, while the economy goes down the drain.

Thank you, Mr. Chairman.

Chairman DOMENICI. Mr. Volcker, if you will proceed, we will then go to each Senator, taking their 5 minutes for either remarks or questions.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, I am pleased to have this chance to meet with you and discuss the current monetary and budgetary situation.

As you noted, I testified before the Banking Committee and my lengthy statement has, I think, been distributed to the committee.[1]

[1] See p. 172.

The Federal Reserve has submitted its usual Humphrey-Hawkins report which contains some analysis of the business situation, the uncertainties that exist, the progress on inflation.[1]

RECOVERY IN SECOND HALF

Let me just summarize that portion of the statement by saying we do believe probabilities are all in the direction of some economic recovery in the second half of this year, continuing through 1983.

We also think that fundamental progress is being made on inflation—which is extremely important in connection with the business outlook as well as on its own merits—and that that progress on inflation has a certain momentum of its own at this point.

Indeed, our best guess is an outlook for somewhat lower inflation rates than the projections that you have been dealing with, which is a good thing, if it materializes in the overall sense. It has some budgetary implications that are adverse in that particular context, but I do think that there is the possibility of a fundamental change in the inflation outlook.

My statement this morning is mostly devoted to the particulars of monetary policy and budgetary problems.

CBO DEFICIT PROJECTIONS

Chairman DOMENICI. Mr. Volcker, could I interrupt for a minute? I should have asked this in my opening remarks and did not.

Yesterday, the Director of the Congressional Budget Office came without having seen the administration's detailed midyear review, gave some ranges and estimates and quite appropriately the media has reported that she has averages significantly higher in 1983, 1984, and 1985 than are in the policy document, the first budget resolution.

It is my understanding that whatever policy you are following, that that evidence of yesterday comes as no shock and will not cause you to change your policy in any direction.

Mr. VOLCKER. We have not made as detailed projections and outlooks as CBO, but the general magnitude of the projections CBO has submitted came as no surprise to us. Indeed, the economic forecasts that you were presented with yesterday came within the range of what we are expecting, with the exception that we are a little more optimistic on the inflation side.

Let me say again, Mr. Chairman, you already mentioned it and I would repeat it with some feeling and emphasis—that I do want to recognize the leadership of members of this committee in particular—and you in particular, Mr. Chairman—in pressing for the budgetary savings that are reflected in the first budget resolution. It is implicit in the forecast that you just mentioned and in our own thinking that that step cannot be the last if we are really going to bring the fiscal deficit under control. But it does represent, in what I certainly recognize as most difficult circumstances from my point of view, encouraging evidence of the willingness and determination of the Congress to undertake the necessary effort—not just this year, but, I hope, in token for the future.

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[1] See p. 196.

OBJECTIVES OF MONETARY AND CREDIT TARGETS

In presenting our monetary and credit targets to the Banking Committee last week, I noted that the basic objective of Federal Reserve monetary policy is the fostering of an environment conducive to sustained recovery in business activity, while maintaining the financial discipline needed to restore reasonable price stability. In my mind those two things must go together. In reviewing the appropriate means to those broad ends, the Federal Open Market Committee at its recent meetings concluded, in effect, that the quantitative objectives for the various M's set forth at the beginning of the year should not be changed at this time, but that we would find an outcome around the top of those target ranges fully acceptable under existing circumstances.

In reaching that conclusion, we considered carefully and explicitly the intent of the Congress, as expressed in the first budget resolution, that the Federal Reserve "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." In the light of that resolution, as well as other factors, we debated the appropriateness of the monetary targets for 1982.

Analysis of past experience suggested strongly that the previously announced targets, particularly with growth around the top of the range, should provide enough money and liquidity to support moderate expansion over the remainder of this year. Pressing aggressively to reduce monetary growth well within the ranges did not seem desirable at this stage of economic developments, particularly in light of the evidence of a demand for liquidity for precautionary—as opposed to transactions—purposes. A sizable increase in the ranges, on the other hand, might imply a buildup of money and liquidity to the degree that it would impair the effort needed to maintain and extend the encouraging progress toward disinflation.

In reaching that judgment, we were conscious that the strong liquidity demands evident in recent months could shift quickly as the economy showed signs of recovery, and that raising the targets could easily be misconstrued as a willingness to tolerate more inflation. At the same time, the committee clearly recognized that possible demands for liquidity in the current uncertain economic circumstances would continue to require a degree of flexibility and judgment in assessing appropriate needs for money in the months ahead.

We could observe that, over the first half of the year, the desire of individuals and businesses to hold assets in relatively liquid forms appeared to be extraordinarily strong, apparently reflecting concerns about the business and financial situation. One reflection of that may be found in the large declines in the velocity of money over the recession period—that is, the ratio of the gross national product to measures of money. That drop in velocity is particularly striking in view of the persistence of high-interest rates, suggesting a heightened desire to hold money or liquid assets relative to earlier trends.

While velocity often fluctuates widely over short periods of time, trends have been much more stable over time. Assuming that ve-

locity rebounds in the second half—as typically occurs early in a period of economic recovery—the targets established at the beginning of the year for the monetary aggregates should be fully consistent with economic expansion in a context of declining inflation. Postwar experience strongly points in that direction. However, the committee explicitly considered the possibility that relatively strong precautionary demands for money could persist. In that event—and it would inevitably involve elements of judgment—growth of the aggregates somewhat above the targeted ranges would be tolerated for a time as consistent with the FOMC's general policy thrust.

EXISTING TARGETS TENTATIVELY RETAINED

In looking ahead to 1983, the committee has decided to retain tentatively the existing targets. The FOMC will review the decision at the start of next year, taking account of, among other things, the behavior of velocity over the remainder of this year. Since we expect that the monetary aggregates will be near the upper ends of their ranges at the end of 1982, the tentative targets for 1983 would be consistent with somewhat slower money growth next year. With inflation declining, the tentative targets should be compatible with continuing recovery at a moderate pace and an improvement in employment opportunities.

In approaching these policy decisions, I have been very conscious of the fact that monetary policy, however important, is only one instrument of economic policy. The attainment of our common objective of a strong and prosperous economy depends also on appropriately complementary policies in the fiscal sphere and in the private sector.

Relaxing discipline on money growth might seem attractive to some as a means of alleviating stresses in financial markets. Indeed, in circumstances in which inflationary expectations and pressures are quiescent, the immediate effect of encouraging faster growth in money might be to lower interest rates, particularly in short-term markets. In time, however, an attempt to maintain lower interest rates by excessive money growth would founder. The net result would be to imbed inflation even more deeply into our economic system, and to make buyers of fixed-interest securities still more wary. Sooner or later, public and private demands for credit would reflect the higher price levels, and savings likely would be discouraged. Market pressures would return in amplified force. Put simply, inflationary money creation provides no escape from the pressures of demands for credit, nor can money creation substitute for real savings.

We can, of course, affect that balance of demand and supply in credit markets by fiscal and other policies, and that is why I welcome so much the effort of the Congress to achieve greater fiscal restraint. I recognize—and more importantly the markets recognize—sizable obstacles remain in converting the intentions expressed in the first budget resolution into concrete legislative action; harmonizing the values and aims of the authorizing and revenue committees—indeed the values aid aims of our citizens—

within the constraints of budgetary discipline is always difficult, and no more so than in today's circumstances.

RISKS ON SIDE OF GREATER DEFICIT

Moreover, the effort this year must be put in a larger perspective. Even if the objectives of the budget resolution are fully achieved for next year and the underlying economic assumptions are realized, the deficit in fiscal year 1983 would be about as large as this year's. Moreover, the risks seem, in my judgment, all on the side of a still greater deficit, despite your important efforts. If the deficit turns out to be larger than expected entirely because of a shortfall in economic growth or inflation—and I would point out that the members of the FOMC anticipate somewhat less real growth and inflation—and thus inflation generated revenues—than the Congress—that "add on" should not be a source of much concern. What is of concern is that you are working from so large a "structural" deficit—a deficit that would exist even in a relatively prosperous economy—and that concern would amount to the extent the targeted savings are not achieved.

As we appraise the fiscal situation today, projected deficits continue to carry the implicit threat of crowding out business investment and housing as the economy expands—a process that would imply significantly higher interest rates than would otherwise result. Your continuing leadership in prodding your colleagues in the Congress to deal with the budget dilemma thus remains crucially important to the outlook for interest rates and the credit markets.

Put more positively, significant progress in paring the deficits will contribute importantly to lower interest rates and reduced strains in financial markets within any monetary framework. That budgetary policy, as we see it, is not fundamentally a substitute for disciplined monetary policy but rather an essential complement.

BUDGET RESTRAINT RELIEVES PRESSURES AND RISKS

When monetary policy alone must carry the burden of dealing with inflation, and when fiscal deficits absorb so large a fraction of the capacity of the economy to generate savings, pressures tend to concentrate on financial markets and on vulnerable credit-dependent sectors of the economy. Conversely, budget restraint relieves those pressures and risks directly, and would reinforce the growing sense of conviction that the inflationary tide has turned.

While the Open Market Committee, in responding to the budget resolution, did not feel that larger growth in the money supply over time would be desirable, let me also say that I believe a credibly firmer budgetary posture would permit us a degree of greater flexibility in the short-run conduct of policy. Specifically, by damping conern about a resurgence of inflation or credit market pressures, fiscal restraint also lessens fears that short-run increases in the money supply might presage a continuing inflationary monetization of the debt. But any gains in that respect will, of course, depend on firmness in implementing the intentions set forth in your first resolution, and encouraging confidence among investors

and borrowers that the effort will be sustained and reinforced in coming years.

I need not dwell on the fact that we are in most difficult economic circumstances, with unemployment far too high, with strong pressures on financial markets, and with a sense of widespread uncertainty. We cannot build a sound program against inflation on a base of continuing recession. But let us recognize, too, that we have come a long way toward turning back the inflationary tide that had come to grip our economy over the decade of the 1970's, and that there is promising evidence of improvements in productivity and efficiency underway. More recently, there are at least some signs that the "gridlock" in the financial markets may be beginning to break up; interest rates, while still very high in historical perspective, have declined to the lowest levels for some time.

The challenge is to sustain that progress during a period of recovery, for it is that progress that is needed to extend and support economic expansion over the long years ahead. Monetary and fiscal policies alike need to be directed, and work in concert, toward that objective. In that context, I and my colleagues believe a continuing dialog with members of this committee is highly constructive, and I welcome your comments and questions.

CAUSE OF HIGH INTEREST RATES

Chairman DOMENICI. Mr. Volcker, I have listened attentively to your statement and I still have a very basic question, and forgive me for its simplicity, but would you tell us in your professional judgment why are interest rates so high in the middle of the worst recession since World War II?

Mr. VOLCKER. I would say there are at least three or four reasons; no one I think, can specify precisely the weight to put on any single one of those, but I think there would be widespread agreement that they are all involved.

First of all, I do think we have the basic fact that we had a lot of inflationary momentum and that the Federal Reserve, in effect, was called upon to deal with that and has done so, I think it is fair to say, without a lot of help from other instruments of policy, particularly when the budgetary situation was going in the other direction.

When you deal through restrictive monetary policy, through limitations on the money supply, with that kind of inflationary momentum, the pressures on financial markets are greater more than would otherwise be the case. You have that underlying fact that puts pressures throughout the financial markets, most particularly on short-term rates.

INFLATION MOMENTUM SLOWED

Chairman DOMENICI. Has the inflationary momentum abated at this point?

Mr. VOLCKER. Yes, I think it has abated, and I hope in a fundamental way. But it is not dismissed. There is still a lot of inflationary cost momentum in the economy. Part of the progress on inflation—which is remarkable if you just look at the price indexes for the first half of this year—is overstated and temporary. We have

been in a recession. We have had declines in energy prices. We have had a favorable food situation. We do not want the recession to last. We cannot expect the energy prices to continue to go down.

When we look at the underlying cost trends, there has been progress, but not the same degree of progress that is reflected in the actual price indexes. It is that kind of continuing momentum of cost inflation, if you will, against monetary restraint, against a recession, that is very adverse in the short run for profits. It is adverse for investment in the short run. It is adverse for employment in the short run. But it is also part of the process of achieving a better inflationary picture and a better inflationary outlook.

The second factor I would mention is precisely that the inflationary momentum has built up over a long period of time. We have had more inflation in this country in recent years than we ever had in history. Memories of that still linger, are still present. There is still a certain amount of skepticism, as you are well aware, and even cynicism, about inflation continuing, and that affects expectations in financial markets and is certainly a factor in interest rates.

The third factor——

DIFFERENCE BETWEEN INFLATIONARY MOMENTUM AND MONETARY POLICY

Chairman DOMENICI. What is the difference between the first two, inflationary momentum and expectations?

Mr. VOLCKER. The first one is that monetary policy has been relatively restrictive against what is actually going on in terms of prices and nominal GNP. Whatever people expect, that is the fact of the matter. I say they also expect inflation to continue, to a lesser degree than before, but there is an expectational factor.

I am distinguishing between expectations and actuality, if you will, at this point.

The third factor I already touched upon—the budgetary outlook. We have gone over this many times. The Federal Government is preempting a large amount of the savings potential, and that means less money available for the private sector. It is no great surprise that businessmen, home buyers and others have difficulty raising money when the Federal Government is preempting a very large share of the total.

If you want to add some subsidiary factors, I think the mere fact that interest rates have been high makes a bond buyer more cautious than he otherwise would be. I think that is a temporary factor but, nonetheless, a real factor.

Chairman DOMENICI. I have a number of questions, but I think—I did not expect your answer to be so long.

Mr. VOLCKER. I wish there was a simple, one-sentence answer, but I am not sure there is.

Chairman DOMENICI. Senator Hollings?

PRESIDENT REAGAN'S TAX CUT

Senator HOLLINGS. I will try to be brief for the other members.

Mr. Volcker, I get the feeling that I am in a sort of economic West Beirut.

Mr. VOLCKER. In an economic what?

Senator HOLLINGS. West Beirut. You are not going to talk to Menachem Begin and Begin is not going to talk to you. Every fellow that has come to town with an adamant position of either a tax hemorrhage or—this first budget resolution here, which absolutely is a bomb—passed less than 2 months ago.

Do you favor President Reagan's tax cut, the third year increment? Do we have to lose another $76 billion next July? Doesn't the fact that we are going to lose that revenue and be borrowing excessive amounts in capital market affect expectations? That is what we are talking about.

Do you favor that tax cut that is effective next July?

Mr. VOLCKER. That is a factor in expectations, but I would refer to the total budgetary situation; I do not think it is right to pick out one element.

Senator HOLLINGS. You do not. That $76 billion—you just got through praising the $21 billion tax increase.

Didn't you think that was a good idea?

Mr. VOLCKER. Yes. My focus, as you know, Senator Hollings, is on the net result and there are many different ways of achieving a net result. I have said all along, if the only way you can achieve the net result is by changing taxes, then you go ahead and change taxes.

Senator HOLLINGS. So you can obtain a three times better result than the $21 billion we just passed this week in the Senate by just withholding, putting the tourniquet on next year's revenue hemorrhage?

Mr. VOLCKER. But in the revenue area alone there are other options. That is a decision the Congress has to make, and I do not have any particular wisdom or recommendation as to which particular direction you should move in dealing with the overall problem.

FIRST BUDGET RESOLUTION STEP IN RIGHT DIRECTION

Senator HOLLINGS. You seem to come to town and tell the President he is right and the Congress it is right in the first budget resolution and neither one of those solve the problem. We get into a worse situation.

Mr. VOLCKER. I repeat in my statement what I have said before. The first budget resolution, which I commend you for, is an important step in the right direction. In itself it does not solve the problem. There is no secret about that.

You have stressed that we are in an "adamant" negotiating position. I am not here negotiating anything.

Senator HOLLINGS. You ought to be. You ought to be negotiating and working for us. We in the Congress have the same intent. We are all saying that.

Mr. VOLCKER. Exactly right. But we are trying to conduct the most reasonable policy that we can. The budgetary situation complicates that. I do not have anything to trade, in a sense. I try to indicate to you what I think is a reasonable, sensible, ccmplementary policy for the common objective which I am sure we share.

Senator HOLLINGS. But just continuing to recite it does not help at all when you know and I know that with 9½-percent unemployment and the industrial plant operating at 70-percent capacity, that that concern of inflation is not near as great as knowing that the Congress is not going to be saving any $140 billion next year, the following year or the next year; and Dr. Rivlin comes with what we all know, not expectations, what the market, you and the bankers and everybody knows, that we are looking at a $130 billion deficit at least for the next 3 years with that first budget resolution, which you seem to think was good, which was lousy.

Can't you give a little now, knowing that that is what is needed to help the economy, the overall economy revive?

Mr. VOLCKER. We are trying to help the overall economy. You speak of giving as if there were something we are holding out on you in the hope that you would do something different. We are not holding anything out. We are trying to do the best job we can in terms of the needs of the economy, and we will continue to do so.

TARGET INTEREST RATES

Senator HOLLINGS. Should we not go back to trying to target interest rates rather than the money supply. There is a proposal under foot that would set the Federal funds rate and fix it at anywhere between 1 to 3 percent above the rate of inflation.

Would you go along with a proposal of that kind?

Mr. VOLCKER. No. I do not know, first of all, how you measure real interest rates. Real interest rates are conceptually an expectational matter. You can try to approximate it, but there is no formula to produce a real interest rate.

Senator HOLLINGS. But, Mr. Volcker, you know how to get real interest rates, an approximation—we will agree it is an approximation but real interest rate is approximately 6 percent.

Wouldn't you say that, right this minute, as Chairman of the Federal Reserve? If someone asked——

Mr. VOLCKER. I do not know which interest rates you are talking about. Real interest on short-term rates, I would guess, are lower than 6 percent; on long-term rates they are probably higher than that.

Senator HOLLINGS. Take the mean. Would you mind taking the mean in between?

Mr. VOLCKER. And then you would have us follow a policy of real interest plus *x*?

First of all, I do not know how to measure the real rates. Second of all, I do not know where the mean is. Third, I do not know precisely what the real interest should be.

Senator HOLLINGS. You do not know how to measure the real interest rate, but you do know how to measure the money supply.

Mr. VOLCKER. The money supply has difficulties in measurement.

Senator HOLLINGS. Thank you, Mr. Chairman.

Chairman DOMENICI. I think we are going to follow the pattern of going to the Senator that was here first and I did not write that down.

Senator Grassley?

BUDGET COMMITTEE ACTIONS MAKING ACCOMPLISHMENTS

Senator GRASSLEY. Mr. Volcker, when we have testimony like we did yesterday that we are going to have a $140 billion deficit for next year, and each 6 months we have deficit projections that are increasing in size, and you take pain, which I appreciate, to compliment us on the work that this committee has done, do you really feel that we are accomplishing anything? I know that you might say things would be worse if we did not——

Mr. VOLCKER. That is precisely what I would say.

Senator GRASSLEY. But I would like to really know, as a Member of the U.S. Senate, making historical budget adjustments and historical tax policies, if I am really accomplishing something. I would like to know if we are going in the right direction, or should we go some other way?

Mr. VOLCKER. I think you are accomplishing something. The fact is that we are going to be better off, it seems to me, by the actions and leadership of this committee than otherwise. If you ask me whether this is perfection, it is not; if you ask whether deficits are not too large, deficits remain too large after your action, but it is not unimportant that they are smaller than if you had not acted.

Senator GRASSLEY. Well, reasonable people on Wall Street and in the financial community and small business people, are going to react negatively to a report hitting the press this morning which says that instead of having a $104 billion deficit next year, we are going to have a $140 billion deficit.

Mr. VOLCKER. I think most people on Wall Street probably anticipated a deficit of that magnitude already. That news would not come as any surprise to them. Perhaps that is why, in some sense, there was not a more dramatic reaction to your earlier actions.

But I will tell you, they would feel much better about a $130 billion to $140 billion deficit—or something in that neighborhood—than if you had not acted; you would be faced with Mrs. Rivlin giving you a higher estimate.

DECLINE IN INTEREST RATES NOT HURT BY BUDGETARY ACTIONS

Senator GRASSLEY. What about the decline in the prime rate last week? Is that reflective of a good feeling about policies that Congress has adopted or is that something that would have happened anyway, regardless of the budget resolution, regardless of the tax policies we adopted?

Mr. VOLCKER. I think to some degree, and I cannot begin to quantify it, that your budgetary actions certainly did not hurt that decline and probably contributed to a background in which declines came a little more easily than they would otherwise. I cannot quantify that and tell you that your action is worth precisely x percent on interest rates.

QUANTIFY THINGS IN TERMS OF MONETARY GROWTH

Senator GRASSLEY. Isn't your whole work though an attempt to quantify things in terms of monetary growth in order to have a beneficial impact on the economy? Slowing inflation is obviously your main concern. You have monetary growth rate targets that

you try to stay within, and you measure your progress against those targets that are previously set.

Mr. VOLCKER. That is right.

Senator GRASSLEY. In fact, you have indicated as much in your remarks today.

Mr. VOLCKER. We try to quantify what we can quantify, but I think it has been a rather persistent refrain in my own testimony that no one of those figures can be taken too literally. We allow ourselves a range. We cite several targets and we interpret them with the best judgment we have as time passes; that has been particularly true this year. I think part of the burden of my statement is that right now we have got to observe what is going on in the economy and make judgments even in attempting to follow those targets; they are not something to be sought if all the evidence runs in the other direction.

MONETARY GROWTH RATE ON ROLLER COASTER

Senator GRASSLEY. Let me change direction.

Are we off the money-growth roller coaster we have been on? For instance, we had a 13-percent growth rate for the last 3 months of 1980 and first 3 months of 1981, then a declining monetary growth rate during the middle 6 months of last year, then late last year and early this year it was back to I think 11 percent, and now it is about 7 or 8 percent.

Are we off that roller coaster?

Mr. VOLCKER. I do not know whether we are or not. That depends a lot on what goes on in the economy. But I do not think that is the heart of the problem.

MONETIZING NATIONAL DEBT

Senator GRASSLEY. From the standpoint of people who are concerned about the national debt being monetized, isn't that reflective of their concerns and hence are they not seeking the protection against inflation taken by people who have money to invest?

Mr. VOLCKER. I do not believe the pattern of money growth through the year is an important factor in that, no.

Senator GRASSLEY. Mr. Chairman, that is all the questions I have.

Chairman DOMENICI. Senator Chiles?

SIMPLE RATE OF MONETARY GROWTH

Senator CHILES. Mr. Chairman, when you testified here last year, you emphasized two things that had to happen to ease the pressure on interest rates. On the fiscal side, you said we have to have restraint. Then on the inflation side we had to make some adjustments in some of the major growth programs that were under strain.

Also, on the inflation side you said we had to see a reduction in wage increases which you said was the real signal about the underlying rate of inflation

When you talked before the Banking Committee the other day, you said that the evidence seems to be strong that the inflationary

side has turned in a fundamental way and I think you emphasized that what was more important for the long run was that the trend of underlying costs in nominal wages had begun to move lower, and that that trend should be sustainable as the economic recovery continues.

So inflation has moved downward and today you said again there has been some restraint from the budgetary aspect, but also in your statement you are saying that fiscal restraint should be viewed more as an important compliment to the discipline of monetary policy than as a substitute. That kind of sounds to me like you are saying, regardless of what is happening in inflation and on the fiscal restraint side, that monetary policy is going to continue the way it has been. That troubles me.

That seems to be following a very rigid, monetarist theory, a Milton Friedman kind of approach, that says we are going to stick to a simple rate of monetary growth and everything else be damned. The country got into an economic mess last year by following a simple supply side formula, into the wall. I sure hope we are not going to follow another simple formula into the wall here.

Mr. VOLCKER. We are not going to follow a simple formula into the wall, if by that—and I do not know how you interpret this in your own mind—you think in the sense that we feel we can set out a monetary number now, for the indefinite future and the whole rest of the world has to accommodate to that monetary number regardless of real changes in the structure of the money market or in the economy. I think that is something that has to be evaluated as time passes, to see whether those numbers are appropriate or not. What I am saying in this statement is, for instance, that during the first half of this year, when most of these monetary aggregates were running somewhat above the target range, under the circumstances that existed we did not think it appropriate to take very aggressive action to bring those numbers back within a kind of simple-minded projection of the ranges. That was a judgment based upon what we saw going on in the economy, what we thought we saw going on with respect to the demand side of the money equation, interest rates and everything else. This was not in our judgment a time to press the money supply still lower, and so we let it run somewhat above our targets, recognizing, I think, the very kinds of concerns that you have in mind.

EFFECTS OF TIGHTENING MONETARY SCREWS

Senator CHILES. Well, I recall when I felt—and I think you felt—that you were like the Dutch boy with your finger in the dike. You were the only—the Fed was the only agency that was trying to make any restraint against inflation. Congress has not changed its fiscal policy. The administration has not and you were the keeper of the grail.

But now, recognizing that there has been a change in these inflationary trends, recognizing that there has been a trend downward in spending, it seems like to me that now there is a point where keeping money tight to offset the effects of the deficit becomes self-defeating. We are at a point where interest is over $100 billion a year, and that is the fastest growing part of the deficit.

So I think we see the following effects when you tighten the monetary screws. Interest rates go up; unemployment goes up; revenues go down. Deficits get higher and then you say we have to tighten the money supply because the deficit is getting bigger. So we take one more big trip around.

Mr. VOLCKER. I am not saying we have to tighten the money supply at all. That is not what my statement says relative to past trends.

I am saying that we are making progress on inflation, and it would be extremely unwise to adopt policies that reverse that kind of progress. I think the prosperity of this country over a period of time depends upon maintaining that kind of progress and getting it further embedded in the outlook, and it would be counterproductive from all points of view to flip-flop on policy and encourage a rebirth, reacceleration of the inflationary picture; we do not want to do that.

Senator CHILES. Well, we said before we are all worried about this real interest rate that is roughly 6 percent, give or take, short-term or long-term rates, higher than historically any of us can remember except I guess if we read back in the early 1930's when it approached that level. In fact, the monetarist theory seems to say there is no way we can have a real interest rate this high. But we've got it.

How long are we going to be able to sustain the kind of unemployment we have without going over the edge; it does not do us any good, whether we have inflation or whether we have budget restraint or anything else, if we shut the engine down?

Mr. VOLCKER. There is no question that we would like to see interest rates lower. The heart of the question is how do you get there, not just in the short term, but in a lasting way. That is one way of looking at the policy problem, and that is the way I look at the policy problem in part. It is just a question of how you can best encourage that development, not only as fast as it can happen, but as lastingly as it can happen.

And that brings me back in part to the inflation problem. I do not think it is going to profit any of us to go all out in an attempt to get interest rates down in the very short run—and we may or may not be successful in the short term—if this effort creates conditions that make rates snap up again in the not-very-distant future and we find ourselves back in the same disappointing, cruel, dilemma that we are in now. We want to work our way out of this in a way that is constructive over a long period of time. That is what all of our efforts are devoted to.

Chairman DOMENICI. Senator Chiles, your time is up.

I guess that Senator Quayle—did you want to ask a question, Senator Quayle?

AVERAGE PRIME INTEREST RATE

Senator QUAYLE. Yes, sir, Mr. Chairman.

Mr. Volcker, what is the average prime interest rate over the last year and a half? Is it 18, 19 percent?

Mr. VOLCKER. I do not know what the average would work out to be.

Senator QUAYLE. Without being exactly precise, about 18 percent?

Mr. VOLCKER. Maybe.

SURVIVAL WITH HIGH INTEREST RATES

Senator QUAYLE. About 18 percent.

I have a very simple, direct question—do you believe that our system and our nation can survive with interest rates as high as they have been the last year and a half? Can we survive as a nation with the continuation of interest rates at that level?

Mr. VOLCKER. You have to give me a lot of other economic assumptions. In Latin America interest rates are 100 percent; they survive, but they have very high inflation and all the rest.

Senator QUAYLE. I certainly do not want to have the standard of living of South America, Latin America. I would like to preserve the standard of living and the quality of life in America as it has been and should be.

Can we survive as a nation, can we survive as a system with these interest rates. It is a straightforward question: Can we survive?

Mr. VOLCKER. I just cannot answer that question without knowing your other assumptions. If certain other things happen, we could survive. But is that a desirable outcome? No. Are those interest rates consistent with what I think is important, greater return to price stability and all the rest, and economic growth in that context? No, they are not consistent with the kind of economy that I would like to see, and I think that is important.

Senator QUAYLE. I tend to agree, I guess, with the thrust of your response, and that is that we cannot. We cannot survive with the continuation of interest rates where they are today. We just simply cannot do it. You can look at bankruptcies——

Mr. VOLCKER. Those interest rates are inconsistent with the kind of economy that I would like to see. I would agree with that.

Senator QUAYLE. So, therefore, it is imperative that we get interest rates down if we are going to have economic survival and I am talking about survival in this country.

Is that fair?

Mr. VOLCKER. You are putting it in an extreme form. We survive——

Senator QUAYLE. I really do not think it is that extreme. Either we are going to survive or we are not going to survive, and I do not think we can survive with these kinds of interest rates the way they are today.

Mr. VOLCKER. It is farthest from my thoughts that we face a choice between survival and nonsurvival. We are going to survive.

APPROPRIATE POLICIES ACHIEVE LOWER INTEREST RATES

Senator QUAYLE. I hope we survive. I really do not see economically how we can survive and prosper with these interest rates which gets me to the next question.

I know that you have complex responsibilities. But what can you do as Chairman of the Federal Reserve Board to get interest rates down?

What can you do as Chairman?

Mr. VOLCKER. Within the limitations of our powers and given what we can do, we think we are following the appropriate policies to achieve that end.

Senator QUAYLE. You think you are following the appropriate policies to achieve lower interest rates?

Mr. VOLCKER. Yes, sir.

Senator QUAYLE. And when will we see lower interest rates around the level of 11, 12 percent? Is that soon?

Mr. VOLCKER. You have some short-term rates below 11, 12 now.

Senator QUAYLE. Do you anticipate the prime rates will come down to that level?

Mr. VOLCKER. Certainly if we are successful over time with our policy, the prime rate will come down to that level and below it. If we are successful in convincing people we are dealing with the inflationary problem, there is no reason we should have double-digit rates of interest in this economy over time.

Senator QUAYLE. If we are successful in convincing people we are dealing with the inflationary problem——

Mr. VOLCKER. That is one factor.

Senator QUAYLE. That is a pretty big if.

Mr. VOLCKER. That is right.

Senator QUAYLE My concern is really interest rates.

Mr. VOLCKER. Your concern is with interest rates, but I am afraid the simple fact of the matter is that you cannot consider interest rates without considering what else is going on in the economy. Interest rates are one very important economic facet that flow out of all economic development, out of all the economic expectations, all the hopes and fears, confidence and lack of confidence in the future. There is just no control that we have over interest rates insulated from all those other factors.

Senator QUAYLE. If interest rates do not come down significantly to a level that will be conducive to having a more productive economy, do you fear Congress trying to exert more authority or control over the Federal Reserve System?

Mr. VOLCKER. Do I fear it? I understand the discussion. I understand the concern. I think it would be sorely misguided in terms of your own objectives.

Senator QUAYLE. Misguided but you do fear it?

Mr. VOLCKER. I do not know whether "fear" is the right word.

Senator QUAYLE. You feel that there would be a possibility of that?

Mr. VOLCKER. I think when people get frustrated, they do things that in another atmosphere they might not do and might not be wise.

Senator QUAYLE. Thank you, Madam Chairman.

Senator KASSEBAUM [presiding]. I do not know who is next.

EVALUATE FEDERAL RESERVE BOARD POLICIES

Senator METZENBAUM. Thank you, Madam Chairman.

Mr. Volcker, the market is down substantially, unemployment is up substantially. Bankruptcies are soaring. The American people

are living in a state of fear and the only thing you tell us is that we are making progress in bringing down inflation.

My real question is, isn't it perhaps time to evaluate the policies that the Federal Reserve Board has followed for the past number of years of tight money and maybe try something new?

Mr. VOLCKER. We are always in the process of evaluating. Whether it is time to try something new is dependent upon whether it is our conviction that something new is going to improve the situation.

RECESSION BRINGING DOWN INTEREST AND INFLATION RATES

Senator METZENBAUM. Well, Mr. Volcker, you claim that you are bringing down the interest rates, bringing down the inflation rate. Isn't that all due to the fact that the Nation is in a recession and that business is not seeking money and that prices are coming down a bit because people do not have the money to buy? Isn't that actually the pattern?

Mr. VOLCKER. The recession certainly enters into it and some of those factors that you mentioned enter into it, yes. Some of those are pretty important factors.

MAKING MORE MONEY AVAILABLE WOULD BE INFLATIONARY

Senator METZENBAUM. You keep emphasizing the great progress on fighting inflation. The fact is that if you had more money in the marketplace there would be greater demand. Therefore, the normal theory is that there is greater demand, the prices will go up and that becomes inflation.

But the fact is that steel mills are operating at 44 percent capacity. Our auto companies are operating at far less than their total capacity. Businesses throughout the country are prepared to sell products, make products and really I do not follow your theory at all that making more money available would be inflationary in and of itself.

Mr. VOLCKER. It is not my theory that economic expansion is at this stage going to cause a reversal of the more favorable inflationary picture. Indeed, I expect—and this is the whole object of policy in a sense—that we can have economic advance, particularly in the light of the circumstances that you cite, continuing side by side with further progress on inflation. Does more money create a problem or not? I suppose the answer is, how much more? We are encouraging the money supply to grow. It is a matter of degree. I have indicated this morning that depending upon the judgment as to what is going on in the economy, very broadly, and on some particular aspects of it, a greater or lesser growth in some of these monetary aggregates may be appropriate.

At some point, yes, I think you can create too much money, which would undermine the progress that we made on inflation and would aggravate our economic problems.

Senator METZENBAUM. We are not anywhere near that point.

Mr. VOLCKER. That is a matter of judgment. That is the kind of judgment we have to make.

BUDGET CUTS SUPPORTED

Senator METZENBAUM. Mr. Volcker, when the Administration was advocating substantial budget cuts, did you publicly support that position?

Mr. VOLCKER. I probably did a great deal of testifying during that entire period of concern about the budgetary deficits.

Senator METZENBAUM. Is the answer yes or no?

Mr. VOLCKER. I do not think it was terribly supportive of any particular position.

Senator METZENBAUM. So you say you did not support the budget cuts?

Mr. VOLCKER. I supported budget cuts, yes. I was referring to the total budgetary program. Yes, I have emphasized the problem of the budgetary outcome and, therefore, have indeed supported budgetary cuts as one means of cutting that deficit, yes.

INSUFFICIENT CUTS CAUSE FOR INCREASED REVENUES

Senator METZENBAUM. If you did that, and I remember very well that you did and your voice was very loud and an effective one, why did you have so much difficulty in answering Senator Hollings' question as to whether you do or do not support a deferral or elimination of a third-year tax cut? That was a very direct question and you seem to say, I do not want to answer specifically. That is a major factor. That is the same as cutting food stamps $2 billion—a lot worse.

Mr. VOLCKER. I have never gotten into the area of whether food stamps should be cut.

Senator METZENBAUM. But you did support all the expenditure side cuts.

Mr. VOLCKER. I do not think I supported them in the sense that you are talking about; I did not support this particular cut or that particular cut. What I said was, yes, from an economic standpoint, cuts are important. I also said, in response to Senator Hollings, yes, to the extent that cuts are not sufficient, I would support increased revenues. When you get into the question of which cuts or which revenue increases, I plead that it is not my responsibility to try to suggest to the Congress, as a matter of social as well as economic policy, precisely which areas deserve priority.

BALANCED BUDGET REQUIRES ATTENTION OF SPENDING AND INCOME

Senator METZENBAUM. Well, Mr. Chairman, one last question.

Over a period of 200 years this country has accumulated a deficit of approximately a trillion dollars. It is obvious now that in 4 years this administration will increase that amount approximately 50 percent, or about a half a trillion dollars. Obviously there is a reason for it that has more to do with both the spending as well as the income.

The cutback in taxes, I believe, for this country, if my recollection is correct, is $750 billion over a 5-year period. They increased defense spending to a trillion and a half dollars over a 5-year period.

Isn't it imperative that if we are really to balance the budget, that we give more attention to the whole question of the money that has been foregone by reason of the tax cut bill as well as the defense spending?

Mr. VOLCKER. As a practical matter, I think you have to look at both sides of the budget. From a strict economic standpoint, as I said before, I think the economy would operate better—I am overlooking a lot of objectives of public policy when I say this—but from a strictly economic standpoint, the more you can do on the budget-cutting side, the better.

Having said that, as a practical matter, it is my own judgment that you have to look at both sides.

Senator METZENBAUM. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Kassebaum?

ADMINISTRATION, CONGRESS, AND FED WORKING AT CROSS PURPOSES

Senator KASSEBAUM. Mr. Volcker, we are in the middle of debating a constitutional amendment to balance the budget. I happen to be one who does not believe that is a solution to our problem. Congress has to make the difficult fiscal and political decisions. But monetary policy also has a considerable impact on the deficits that we face. This has been touched upon by almost everyone that has been asking these questions.

And so we can talk all we want to about a balanced budget, but we have to recognize that we can go just so far at a particular point and I think we, in good faith, did make an effort to do that. I think we could have done better. But at this particular juncture, it seems to me that monetary policy is really working counter to efforts that we have attempted to make here and that the administration has attempted to make and that bankrupt companies and unemployed workers do not pay taxes, which is certainly having a budget impact that directly relates back to high interest rates at that particular point.

I guess what I am saying to you is, and obviously you are well aware, that political considerations, there is usually a hue and cry raised about the fact that the Fed has to be brought under control and that Congress perhaps should do so. I have always believed that the Federal Reserve System should remain an independent agency. But I think that at this point the frustration that we all feel is important and that really we seem to be working at cross purposes.

How independent do you believe the Fed can be or should be, and at a critical juncture such as this, from Congress and the administration?

Mr. VOLCKER. Let me say, first of all, that I do not agree at all with the presumption that we are operating at cross purposes. There may be some disagreement as to what, in fact, to do, but I do not think there is any question about our common objective; the only disagreement can be over the judgment as to how to achieve that objective. I think that goes to your question. The Congress set up the Federal Reserve the way it is set up, and Congress can do what it wants to; we operate under delegated powers from the Congress, in recognition that these are difficult and sensitive issues

and that monetary policy will not be assisted over a period of time by exposing it to any more direct political pressure—perhaps most explicitly in the kind of period we are in now, where the temptation is to seek out and strike out for some particular objective in the short run which may or may not be consistent with what is desirable in terms of our common objective over a longer period of time.

I think perhaps that is explicitly the situation we are in now. If I knew how to wave a wand, as I said before, if I knew some device so that we could magically get rid of all these problems in the economy and have interest rates lower, I would be derelict if I did not wave that wand. I do not have any wand like that. These problems have built up over a long period of time. Many of them are not susceptible to a "quick fix" from monetary policy or from anything else.

You talk about the liquidity of business, which feels very strained at the moment. I will tell you statistically that liquidity is not essentially different now from what it was last year or the year before. There has been a decline in liquidity in American businesses for literally decades. That did not seem too bad to businesses when things were fairly prosperous, and interest rates were low, and real interest rates were negative. They always felt they could borrow.

Now we have a recession. We have more uncertainty, and suddenly with the liquidity positions they desired a few years ago, they feel strained. There is no way I can correct that overnight by any device at hand, because part of it stems from the behavior of businessmen over a period of years. That needs to be corrected. And part of that behavior stems from the inflationary situation we have faced.

DISCOUNT RATE

Senator KASSEBAUM. I agree with all of what you are saying. I guess I am saying that at this point we are here somewhat on the fiscal and monetary policy. Certainly over the last several years there were periods of time when monetary policy was really the only policy working. But now that there has been some direction taken, and we all would have differing views perhaps on how much it should have been or how much more we wish it might have been—that then monetary policy has to show some signs of adjustment, perhaps the lowering of the discount rate. This was some adjustment.

Do you envisage the discount rate dropping any further in the next couple of weeks?

Mr. VOLCKER. That is a judgment that we always face on a week-to-week basis. That decision will be made on the basis of what we think is most constructive in terms of what is happening in the market and what the needs of the economy are I do not want to prejudge that this morning.

If I can make a couple of comments about your premise, I welcome—there is no question about it—the progress that this committee and the Congress has made in trying to deal with the budget deficit. But I think it is quite evident from the comments made this

morning and yesterday that the budgetary outlook has not been revolutionized in the sense that we are on a clear path. It is still a serious problem. I do not see the same kind of tradeoff that some of you may see between fiscal and monetary policy. In other words—to put it perhaps too colloguially—turning to an imprudent, undisciplined monetary policy is not a substitute for a disciplined fiscal policy. If we did, it would undercut the objectives you are looking for from fiscal policy. We would be much better off if these policies worked in a coordinated way.

As the Chairman's question and my first response to him this morning suggested, part of the reason all these pressures have converged on financial markets is that so much of the restraining, disciplinary effort has been left to monetary policy in contrast to fiscal policies. Some of those pressures would have been relieved by a different policy mix, but that does not say that we should have a decided by faster growth in the money supply, which over time would mean we would not have dealt with the inflation.

The question is how policies can better complement, not necessarily substitute, for each other.

Chairman DOMENICI. Senator Riegle?

MONETARY POLICY HAS FAILED

Senator RIEGLE. Chairman Volcker, we met and talked many times, most recently within the Banking Committee last week. I think it is clear, and I think what members of this committee are saying to you in a variety of forms, and what is clear to me, is that our monetary policy—your monetary policy has failed and I think it is time to change it. I think the high interest rates are costing us far more than we are gaining. It is costing us hundreds of billions of dollars of lost production, huge Federal deficits, and a needless deficit, and high interest rates in the entire society and economy.

HIGH INTEREST RATE POLICIES CRUSHING ECONOMY

The economy by any measure is in deadly serious trouble. Every top financial person in this country that I talk to publicly and privately says that to me. I think the high interest rate policies are crushing the economy. We are destroying thousands of businesses and not just weak and poorly managed ones. We are destroying businesses that have been in operation for decades and are well managed. We have put, by these high interest rates, now over 10½ million people out of work. That by itself I think borders on criminal neglect by our Government. We are making our products uncompetitive in foreign countries. Our trade deficit is widening and we are losing world markets that we are not going to get back, destroying businesses in the process.

The auto companies, the steel companies, small businesses, agriculture, even financial institutions are being severely damaged and I am talking about outright failures, things that even a few months ago were not thought possible.

DEFICITS OUT OF CONTROL

The deficits are hopelessly out of control. That is what Alice Rivlin said yesterday. I think her numbers, if anything, are optimistic.

Today, on the front of the New York Times, it is obvious that the President himself is not prepared to budget on this deficit problem. The headline of the lead story here says, as follows, "Aides Say Reagan Objects to Ceiling on Military Funds," and this is the way it reads:

> President Reagan does not feel bound by the ceilings on military spending for 1984 and beyond that were set by Congress last month with the White House's blessing, administration officials said today "In a step likely to hurt his relations with his Republican allies, Mr. Reagan was said to be planning to use his mid-year economic report, due later this week, to signal an intention to seek higher levels of military spending."

And it goes on in this vein.

If the lid is off in that area, the better portion of the budget as it is anyway, there is absolutely no way we can get the deficit under control around here and nobody is going to be fooled by it. So the economy is caught in this high deficit, high interest rate trap. It is certain to cripple any recovery that starts. I think even a falloff in the market in the past few days and the uptake in interest rates after some decline indicates that a lot of sophisticated people understand that the policies as they are now in place cannot work, will not work, and that they will cripple any recovery that starts.

So I think we are at the point, and I think you recognize it here today, I hope you will recognize it in your own mind shortly, that the old game is over. You are not going to be able to continue to pursue these monetary policies the same way and perhaps the lowering of the discount rate by half a percentage point and the fact that you have said in the last week that you plan to stay at the high end of your monetary target and maybe go above them, maybe indicates that you are beginning to see it yourself.

NEW MONETARY STRATEGY NEEDED

But I think we need a new monetary strategy and I think we need it now if we are going to avoid a depression because there is no other way out of this trap as things stand now and particularly with the President saying today the lid is off on military spending on out through 1985 and beyond.

So I would like to suggest to you that we shift policy and go back to targeting the interest rate on some basis, presumably with some historical range above the inflation rate to give people a true rate of return on their money rather than targeting these monetary aggregates. Targeting these monetary supply numbers, looking at graphs and charts that have showed what has happened since that policy went into effect in 1979, is looking at a roller coaster. They are all over the lot. Try as you might, or as anybody might, try and sustain an economic policy with that kind of pattern of gyrations and interest rates I think is clearly impossible and it is not working.

Now, we are at a point where the entire economy is in jeopardy and hangs in the balance. So my earnest appeal to you today is to

consider these facts now and review these policies with an eye to changing them because it looks as if whatever you have been saying to the President privately and to his economic advisors is not getting through. The Congress, for its part, has been unwilling or unable to make the kind of changes in the overall fiscal situation that are needed and the deficits are skating up into the range of $200 billion or perhaps even higher than that when we get out to 1984 and 1985.

My earnest appeal to you is to take a look at these facts and consider a major change in monetary policy before it is too late and before we find ourselves with the kind of damage and upheaval in this country that we cannot repair or that would take us decades to do.

My question to you is——

Chairman DOMENICI. Time is up, Senator.

BORROWING NEEDS

Senator RIEGLE. I would like to know what you see as the borrowing needs, what you are projecting as the Federal Government's borrowing needs at third quarter and fourth quarter of this year, what your best estimate is, numbers of billions of dollars.

Mr. VOLCKER. Our own estimate for the current quarter is something in the neighborhood of $50 billion.

Senator RIEGLE. $50 billion for this quarter?

Mr. VOLCKER. Yes, and I would not expect it to be widely different from that in the next.

Senator RIEGLE. Roughly $50 billion in the fourth quarter?

Mr. VOLCKER. These are not seasonally good quarters.

Senator RIEGLE. So you see Federal borrowing of approximately $100 billion in the two quarters that we have now commenced in the last half of this year?

Mr. VOLCKER. I would hope it could be somewhat less than that but that is a round number.

Senator RIEGLE. But those are your estimates?

Mr. VOLCKER. Maybe a little less.

Senator RIEGLE. My time is up but I say that that $100 billion of borrowing makes my earlier point. I just do not think that the economy is going to take that stress and strain if the interest rates stay at that current level.

NO MAGIC IN MONETARY POLICY

Mr. VOLCKER. If the chairman would permit me to comment briefly on your earlier comment, I do not agree with the premise that monetary policy has failed. My concern about your statement is that it seems to be based upon a premise that all of the rest of the world can be out of joint and we can solve all the problems with monetary policy. There is no magic in monetary policy to solve all these problems if everything else is going off in a different direction. That would be the burden of my response, that you just cannot sit there and look at the fiscal situation, see that it is going to get worse and do nothing about it, in the hope that you can cure it by monetary policy. There is no cure to that in monetary policy.

Senator RIEGLE. The question is whether monetary policy is adding to the problem or helping the problem and I think the weight of the evidence now is that monetary policy is adding to the problem and not solving it.

Mr. VOLCKER. I do not believe it, but it is a matter of judgment.

Chairman DOMENICI. Thank you, Senator.

On our side I do not know who is next.

Senator BOSCHWITZ. I am not sure. I see my colleague yields to me, so I will proceed.

I apologize, Mr. Chairman, for arriving somewhat late. I was interested in some of the comments of Chairman Volcker. My friend and colleague from Michigan seems to lay a heavy load on the Federal Reserve including 10½ million jobless, and destroying business policies now in place. I would remind my friend from Michigan that when the present administration came to power, interest rates were about 6 percent higher, unemployment was not as high but was high, inflation was approximately eight points higher than it is now or perhaps even more than that. Chairman Volcker, apparently, the Senator from Michigan wants you to wave the wand that you said you did not have in your hand to wave.

I am not sure how we can turn on and off interest rates like a faucet. I am not sure how the economy can just be set in a new direction by changing policy. I do not believe it.

I am not quite sure what the Senator wants. He just designated that there should be a change.

TARGET INTEREST RATES BY USING INFLATION RATE

Senator RIEGLE. If the Senator would yield, the idea that was suggested that many people are supporting is rather than targeting monetary aggregates that we go back to targeting interest rates themselves and to target them by using the inflation rate and then some real rate of return beyond that.

Senator BOSCHWITZ. Does the Senator suggest that we establish interest rates?

Senator RIEGLE. Interest rates are presently being established by monetary policy within the Federal Reserve System. That is why we are meeting here.

Mr. VOLCKER. I do not agree with that.

If I might interject something, we do not have a high interest rate policy. As a prior clarification, you suggest we go back to targeting interest rates. I think that is an incorrect perception of what the Federal Reserve ever did, if you mean that we were trying to hold interest rates to some particular real interest rate. It is true, using the Federal funds rate as an operating instrument, we tended to try to stabilize the Federal funds rate for short intervals of time, as a means of reaching certain monetary objectives. That is quite a different thing from trying to stabilize interest rates over a period of time in accordance with some real interest-rate target.

Senator RIEGLE. It had that effect and it worked much better.

Mr. VOLCKER. I do not think it had that effect; but I might point out that the Congress spent a good many years encouraging us to target monetary aggregates more carefully a few years ago.

98-044 O - 82 -- 5

Senator BOSCHWITZ. In any case, if you have that power to set interest rates, I hope you would not stop at 10 or 12 percent, 3 or 4 percent would be much nicer.

Chairman DOMENICI. How much?

BUDGET GROWTH SLOWED

Senator BOSCHWITZ. Three or four percent. If you also have that power, you might also have power over inflation. It would be nice if you would through our monetary policy reduce that as well.

I really have a difficult time understanding how people feel we can turn interest rates and the economy on and off like a faucet.

Let me get to my question, Mr. Chairman.

When I came here, and this is in response to my colleague from Michigan, the first budget I voted on, in the spring of 1979, was the 1980 budget. That was presented by President Carter, $532 billion. The next year, 1981, it was $627 billion, and just before he left, President Carter left us with a budget of $739 billion. We in this committee have worked backward and put some squeeze on the increases. Despite the fact that my friend and colleague from Michigan talks about deficits skating up to the $100 or $130 billion mark, I respectfully suggest that it is not our fault. We are trying to restrain the growth of spending and I respectfully state that he and others on his side are making it more difficult for us.

In any case, it went from $532 billion to $627 billion to $739 billion. This budget that we have passed is approximately $770 billion; is it not?

Chairman DOMENICI. Correct

Senator BOSCHWITZ. So we have slowed the growth of the budget, and I would like your comment on that and on the past tax bill, could we also have your assessment of what the Congress has done? Are we on the right track? What else should we do?

Mr. VOLCKER. I hope you will do more, but I certainly welcome that resolution and the implementing actions as necessary steps in a direction that will certainly moderate the budget deficit and provide, to that degree, a healthier climate for the economy and for the financial markets.

Senator BOSCHWITZ. You think, therefore, that the steps in the direction we have taken are positive ones?

Mr. VOLCKER. Yes.

TAX BILL

Senator BOSCHWITZ. Do you think that we, Mr. Chairman, should revoke the 10-percent tax decrease?

Mr. VOLCKER. We had some colloquies on that earlier. I refused, I think accurately reflecting my earlier comments, to take a specific position on that. I have said that I think it is important to make further progress in reducing the deficit from a purely economic standpoint. The more you can do on expenditures, the better. As a practical matter, this year, I suspect, you have to look at the revenue side, too. Whether that is the best revenue measure to look at is your decision.

Senator BOSCHWITZ. Mr. Chairman, we closed a number of so-called loopholes recently in the tax bill Absolutely every one of my

colleagues on the other side of the aisle, with the exception of one, voted against it and yet under their aegis and the Congress they controlled, those loopholes were opened. Yet, for the first time, we are finally reducing the effective tax rate of all citizens with a 5,-10, and 10-percent decrease and yet that is the one that they now wish to remove.

RAISE REVENUES FROM ENERGY AREA

Mr. VOLCKER. If I can just point out another area, for purposes of example. You mentioned the loophole closing possibility and some progress made there. I would like to see whether other objectives could not also be met by any necessary action that had to be taken anyway, and the energy area keeps coming to my mind as one possibility. It does not seem to be very popular in the Congress, but it is a way of raising revenues that would have some other constructive effects.

Senator BOSCHWITZ. I would support that.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Sasser?

INTEREST RATES NOT FOLLOWING INFLATION DOWN

Senator SASSER. Thank you, Mr. Chairman.

Mr. Volcker, I happen to believe that interest rates are going to come down. I think they are going to come down either as a result of actions that you take in concert with this administration or they are going to come down in the wake of a collapsing economy.

Now, we have 548 business failures in the week ending June 17. A similar week in 1932, we had 612 business failures. We are seeing now, in the wake of this high interest rate policy we are pursuing for almost 2½ years, that the badly managed businesses are gone. Those that are reasonably well managed are also either gone or on the verge of going; and those that have been well managed for many, many years are now getting into very serious difficulty. We have experienced over the past 2½ years, as you and I discussed before the Banking Committee the other day, the highest real interest rate I think that we have experienced in this century. You and I have some disagreement about this. These real rates, high real interest rates, come into being shortly after you assumed your position as Chairman of the Federal Reserve Board. Now, no one seems to have any explanation as to why real interest rates are not following inflation down.

You told me before this committee 2 or 2½ years ago that inflation would start coming down at some point if we held to the course that was then being embarked upon with regard to monetary policy. We have seen inflation come down but we have not seen real interest rates come down.

My question to you is, why won't they come down? Milton Friedman himself, I suppose, the guru of the monetarists, has no explanation for that. He cannot tell us why real interest rates are not following the rate of inflation down. We see in 1980 real interest rates were 6 percent; that is, interest rates corrected for inflation. In 1981, they were 9.5 percent, interest rates corrected for inflation

Economists are telling us now that they do not see much chance of the prime rate dropping much below 15 percent this year. We are talking about a rate of inflation of 7 to 8 percent. So we are going to have real prime interest rates this year, corrected for inflation, 7 to 8 percent.

Why won't real interest rates come down? Why won't they follow inflation?

NO PARTICULAR STABILITY IN REAL INTEREST RATE

Mr. VOLCKER. I gave an extended answer to that question earlier to the Chairman, which I hesitate to repeat in its fullness. I think there are a variety of reasons that account——

Senator SASSER. You said inflationary momentum was I think the principal thrust of your answer.

Mr. VOLCKER. And the budgetary problem, and the pressures put on monetary policies; all those were the thrust of my answer.

Let me note that I do not think that the historical record shows any particular stability in the real interest rate, but I think there is a tendency, over time, for the average level to be very substantially lower than it has been. I do not think there is any question about that, and I do not think there is any question that they are extraordinarily high now.

Senator SASSER. Alan Greenspan says in an article in Business Week a short time ago that real interest—it is uncommonly rare for real interest rates to exceed 3 percent and we have been seeing the matter average much higher.

Mr. VOLCKER. It is certainly uncommonly rare to see them anywhere near where they are now.

Let me put a footnote on your comment on the prime rate. It is also historically extraordinarily high compared with other interest rates, so when you look at the prime rate alone, you get a somewhat exaggerated view. Your comment in substance is that if you look at the prime rate as the measure of real interest rates, you get a prime rate that is historically maybe as much as a couple of percentage points out of line with other short-term rates, maybe more than that, so I do not think I would want to rely on the prime interest rate alone—or primarily—in making a judgment, but it does not take away the force of your point that real interest rates are high.

HIGHER DEFICITS ANTICIPATED

Senator SASSER. Mr. Chairman, we heard Dr. Alice Rivlin testify yesterday that we could anticipate budget deficits in the neighborhood of $140 to $150 billion. The administration is now telling us, I think the Secretary of the Treasury, Mr. Regan, that he anticipated budget deficits in the neighborhod of $111 billion.

Do you agree with Dr. Rivlin's estimates or do you agree with the administration's estimates of what we can anticipate by way of budget deficits?

Mr. VOLCKER. I suppose I have my own estimate, but what Mrs. Rivlin is saying is that she expects somewhat lower growth than you used in the assumptions on which the budget resolution is based and that the administration is probably using at this point in

time; that accounts for a portion of her higher estimate. As I noted in my statement, we also expect somewhat less inflation, and hence inflation-induced revenues.

Our analysts also think that you probably will not get the full effect of actions taken in the budget resolution; that they are not going to be fully implemented through the administrative savings and other elements assumed in that budget resolution.

So there are some technical as well as economic assumptions that pose the risk of a higher deficit than you assumed in the resolution. If you put those possibilities together, I do not think Mrs. Rivlin's estimate is unreasonable.

Senator SASSER. I see my time is up.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Symms?

TRY TO STABILIZE MONEY SUPPLY

Senator SYMMS. Thank you, Mr. Chairman.

Senator Sasser, I talked with Milton Friedman a couple of weeks ago and we might ask Chairman Volcker to comment on this. He says he does have an answer for why we have so many problems. He said if all of you in the Congress would just replace the Federal Reserve Board with a clerk to run the computer, that you would have a steadier growth of money and it would work easier. That is what he told me. That is easy for him to say on the outside.

But, Chairman Volcker, I asked you about this once before, and I want to come back to this same question and it does relate somewhat to Friedman's treatise that we should have a computer that cranks out a fixed amount of money every month so there is predictability to the people that are making long-term investments.

As you know, there are other economists that think we should link the dollar with gold to extend the economic horizons of the people that have the stability in the money growth. But with the massive regulation we have seen in financial institutions, how do you evaluate the success of monetary targeting or do you have any ideas on how we could reduce the fluctuations of big money supply one week and the next week or is this weekly money supply report something that is too often to be reported and some of the people on Wall Street and so forth, they worship the shrine of the money supply figure every Friday.

Are there other figures they should be watching?

Mr. VOLCKER. I certainly think there are other figures they should be watching. You asked specifically if there is anything we can or should do to try to stabilize the money supply on a weekly or monthly or even quarterly basis. My answer to that is no. Money supply fluctuates for a variety of reasons, and I am afraid that what could be done technically to, at the extreme, somehow put it on a computer and produce a nice even figure from week to week or month to month would only exacerbate some of the other problems. For instance, we would have had a much lower money supply during the first half of this year, if we had responded to the high growth in January by saying that growth had to be substantially lower over the rest of the first half to compensate. I cannot bring myself to believe that would have been correct policy under

the circumstances that existed. I think there has to be an element of judgment, depending on what is going on in the economy.

REVIVAL OF LONG-TERM BOND MARKET

Senator SYMMS. Do you think there is any way that we are going to see a revival of the long-term bond market without cutting entitlements?

Mr. VOLCKER. Before you said "entitlements," I was going to say yes. That remains my answer. I think we will see a revival of the long-term bond market as, over a period of time, we demonstrate our ability to deal with inflation. I think dealing with the budgetary problem would hasten the improvement in the bond markets, and I do not think you can exempt the entitlements program from the effort to deal with the budgetary problem.

REGULATION OF FINANCIAL INSTITUTIONS AFFECT FINANCIAL ASSETS

Senator SYMMS. How does this regulation of the financial institutions affect the financial assets? You are talking about M_1.

Mr. VOLCKER. I think it makes it more difficult to judge the meaning of those figures because the economic substance of those figures changes when you have a change in market institutions or market regulations. We try to make judgments about that; I think we are forced to.

The judgments that one makes before the fact are necessarily rough. You have to observe what is going on in the market to get some sense either from interest rates, economic behavior, velocity, or whatever, as to what the impact is

Most institutional changes are not so abrupt that they create a large discontinuity in the figures all at one time. There are some exceptions to that. In the beginning of last year, when we introduced NOW accounts nationwide, the figures changed very rapidly. NOW accounts were introduced by legislation, and we could make some reasonably good estimate of what the impact was, but they clearly distorted the figures for some months.

Senator SYMMS. Is it possible though that there is less money out there for transactions than is estimated because of all the NOW accounts and money market funds?

Mr. VOLCKER. You have two conflicting considerations. In general, technological change aspect of financial innovation goes in the direction of more money for transaction purposes than we measured. A leading example of that is that we do not include money market funds in our measure of transactions balances M_1, but we know to some extent money market funds are used for transaction purposes. NOW accounts themselves work in the opposite direction; that is, we include them in our measure of transactions balances, yet to some degree they have elements of a savings account.

Just taking those two examples, you have a balancing of forces, and you have to make an estimate. It is for that reason that I say, do not look at one aggregate and do not feel that you can keep that aggregate or should keep that aggregate on some pinpointed target that is set before the event. We cannot do so and it would be dangerous to try to be that precise about it. Rather, we look at a vari-

ety of factors. That is the only protection that we have from the kind of problem you point out.

Senator SYMMS. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Exon?

BALANCED BUDGET AMENDMENT

Senator EXON. Thank you, Mr. Chairman.

Mr. Chairman, welcome.

I will be very brief.

Do you think the balanced budget amendment that is being considered in the Congress is a partial answer to the budgets we face with ever-increasing deficits, and what do you think—what effect do you think passage of that, at least in the Senate, might have on the money market?

Mr. VOLCKER. In answer to your first question, I have expressed some considerable doubt about its workability, although I have great sympathy with its purpose and the considerations that underlie it. But I have had great doubts about its workability.

In terms of an impact of its passage on money markets, I would be doubtful that you would notice an effect.

MONETARY POLICY

Sentor Exon. Are you and the President in agreement on monetary policy?

Mr. VOLCKER. I always have to answer that question by saying that it is probably better to ask him.

Senator EXON. From your perspective——

Mr. VOLCKER. My sense is that the general thrust of monetary policy has consistently been supported by the administration.

FISCAL POLICY

Senator EXON. Are you and the President in agreement on fiscal policy?

Mr. VOLCKER. I may have been more concerned about the deficit some time ago than the administration was, but recently I do not detect any differences. They have been working very hard, I think, to take measures to restrain spending and to support very strongly the kind of tax bill that was supported in the Senate.

Senator EXON. Are you testifying that you think that the administration has been effective at restraining spending when we are facing the highest spending level and the highest deficits and the highest national debt in our history?

Mr. VOLCKER. I think they have been effective at keeping expenditures below what they would otherwise have been, yes.

Senator EXON. Including the deficit projections that were given to us yesterday by CBO? Do you think that is proper restraint on spending? Compared with what?

Mr. VOLCKER. I think those deficits are still too big. Looking out to future fiscal years, I think the implication is that a lot of work remains to be done. But I do not think that it is counter to the point that the administration has been making an effort with, I

would think, some considerable effectiveness to try to restrain spending below what it would otherwise be.

Senator EXON. Including defense spending?

Mr. VOLCKER. No. I think they have a different philosophy on defense spending, although they have made cuts there relative to their original proposals.

Senator EXON. Let's not carry that any further. I guess that I think it is very sad indeed when the Chairman of the Federal Reserve Board seems to carry on the myth that is going on in this country that we are reducing spending. The facts of the matter are we are spending more money than we ever spent before. We are raising the deficits faster than we ever have before and we are going into debt faster than previously in history.

Mr. VOLCKER. If there is any implication that I do not think spending is rising and the deficits are too big, let me correct that. Unfortunately, I could imagine circumstances in which they would have been even bigger without an effort at restraint.

GOOD CHANCE INTEREST RATES WILL DECLINE

Senator EXON. I suspect that is always true.

Let me go to the next question.

There has been some talk about what is your responsibility, Mr. Chairman. I have high respect for your integrity, although I disagree with some of your policies. I would simply get to—what are your responsibilities? I feel that especially during these critical economic times, your responsibility transcends what I detect as your perception of your responsibility. I cite the fact that many businessmen and many farmers and many individuals today are hanging on, literally, with their fingernails, deciding whether they should continue or cash in their chips now. There has been a lot of cheer leading going on about the economy about ready to turn, going back to the ranch in California a year ago in August when the tax bill was signed into law, as a new beginning of a new day with regard to the economy of this country.

Many of those individuals are hanging on, believing and hoping that there is going to be a significant decline in real interest rates.

Now, I think you have a responsibility here, although I recognize and realize that you do not like to be pinned down on numbers.

Can you, for those people that are seeking guidance today as to what their next course of action should be during these very difficult times—what do you think they should be expecting in interest-rate reductions in the next 6 months or, let me phrase is this way, do you think there is any chance that real interest rates would come down to somewhere near a normal nominal figure of 3 percent over inflation?

Mr. VOLCKER. I am not going to give you an answer as you anticipate, it in numbers; and I do not know how to measure real interest rates so closely. You asked me if there is a good chance, indeed a probability, that interest rates, nominal and real, will decline in the future; I do, indeed

Senator EXON. Thank you, Mr. Chairman.

Chairman DOMENICI. You got a very conclusive answer.

Senator EXON. I got very little.

Chairman DOMENICI. Senator Andrews?

SIZE OF DEFICIT AFFECTS INTEREST RATES

Senator ANDREWS. Thank you, Mr. Chairman.

In all this questioning, we keep going round and round the bush on what affects the interest rates. What exact deficit amounts does the Federal budget have to reflect before interest rates are lowered to a reasonable level?

Mr. VOLCKER. There is just no numerical answer to those questions. What I will tell you is, the lower you make the deficit, the better off we will be in terms of interest rates. I could give you a ridiculous answer. If you suddenly balanced the budget, interest rates would go way down. But you are not going to do that. I am not even sure that would be desirable policy, to wave a wand and make the deficits disappear.

If you do make a $10 billion improvement, that deficit is not going to revolutionize the market, but it goes in the right direction.

Senator ANDREWS. But you agree with what Mrs. Rivlin told me, that there is a direct correlation between the size of the deficit and the amount of interest rates?

Mr. VOLCKER. Yes.

SUPPLY-SIDE INCENTIVES

Senator ANDREWS. Now, we heard a lot about supply side from the folks on the other side of Pennsylvania Avenue, that supply side will solve all our problems. There seems to be more supply siders in The White House than anywhere else in the country.

Do you feel that supply side concept will work?

Mr. VOLCKER. I guess it depends on what you mean by supply-side theories.

Senator ANDREWS. The incentives, the lowering of taxes, the stimulation.

Mr. VOLCKER. I think they work in a constructive direction. You ask me whether 16-, 17-percent interest rates are bad for investment Yes, that's bad.

Senator ANDREWS. It dampens the so-called initiative you are getting. So the tax cut might well be reduced somewhat because we will get more stimulus by reducing interest rates than we do by continuing with the tax cut.

Mr. VOLCKER. If you are going to raise taxes, obviously the best thing to do would be to do so in a way that preserves all or as much as possible of that kind of a stimulus; I think there are ways of doing that.

Senator ANDREWS. But the tax cut should be adjusted to make sure that you do not have excessive interest rates which preclude the investment type incentives that the tax cuts were supposed to stimulate.

Mr. VOLCKER. The revenue-expenditure imbalance should be corrected. To the extent you have to do that through the revenue side, you have to.

Senator ANDREWS. In your testimony to the Senate Banking Committee recently, you acknowledged that the battle to reduce inflation had been achieved in the context of serious recession. The

question that that begs is, is it worth it? Is it worth not having inflation by tipping us into the deep recession we are in?

Mr. VOLCKER. I do not think it is an either/or question. If it were, your question would be very relevant. But dealing with inflation is going to be fundamental to producing a prosperous, productive America over the next decade.

Senator ANDREWS. But isn't there a better way of solving inflation than dumping us into recession?

Mr. VOLCKER. I do not think that is the only reason we are in recession. Ideally, there are better ways of doing things than what we did. The Federal Reserve controls only one aspect of policy. We were faced with a different question. If nobody else was going to join in, should we make an effort anyway?

The answer to that, for myself, was clearly yes. But if you ask me whether I could think of a better balance of policies than what we had, the answer is also, yes.

Senator ANDREWS. Sure, we all have 20–20 hindsight.

Mr. VOLCKER. Even with foresight.

INDICATIONS THAT PRIME RATE IS DROPPING

Senator ANDREWS. Let us look at today's situation because that is what we are forced to deal with. There are some indications that the prime rate is dropping. Is this because of a change in the perception that Wall Street has concerning these deficits or is there some other explainable reason for this drop?

Is it finally because we in Congress have realized that $750 billion of tax cut in 5 years is too much?

Mr. VOLCKER. I do not think that hurt, but I would not attribute a direct cause and effect between your actions and the drop in the prime rate; your actions certainly did not hurt.

Senator ANDREWS. Even helped a little?

Mr. VOLCKER. It even helped a little.

Senator ANDREWS. That sounds better than it does not hurt.

Finally, some economists have indicated that the prime rate is going to rise again no matter what we do in regard to adjusting of the large deficit figures. Are you of the same opinion?

Mr. VOLCKER. No, I do not think that is inevitable.

Chairman DOMENICI. I did not hear the question.

Senator ANDREWS. The question was simple. Some economists have indicated that the prime rate will rise again, irrespective of what we do considering these outyear budget deficits.

Mr. VOLCKER. I responded to Senator Exon before. He did not think it was much of an answer. I think the probability is that we could see declines in interest rates even with the economy expanding in coming months.

Senator ANDREWS. But what if we can get the outyear deficits even more under control?

Mr. VOLCKER. No question of that. A major hazard, the one that the market focuses on more than anything else, is that deficit problem.

Senator ANDREWS. And the outyear deficits are the things that are giving the money markets trouble when they look at the fact

that we are going to be in the market borrowing huge amounts to finance the deficits.

Mr. VOLCKER. In two senses, they see that the deficit is persistent through time, and being in the money market to such a degree is a crippling factor in terms of getting interest rates down. They also recognize that, looking at the next 6 months, there is not much you can do. So as a practical matter, you have to look beyond that.

Senator ANDREWS. For the long haul, the $240 billion deficits give the money markets fits, and that is one of the reasons we have high interest rates?

Mr. VOLCKER. That is correct.

Senator ANDREWS. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Hart?

ECONOMIC EFFECT OF INCREASED DEFENSE SPENDING

Senator HART. Mr. Chairman, Mr. Volcker, you said in response to a question by Senator Exon that you felt the administration was strongly attempting to hold down spending.

Did you happen to notice the statement attributed to White House sources in today's paper about the desire or decision of the White House, the President of the United States, not to follow the outyear projections by this committee and the Congress on defense spending for 1984 and 1985?

Mr. VOLCKER. I had not seen it, but Senator Riegle mentioned it this morning.

Senator HART. What is your response to that?

Mr. VOLCKER. I do not think I have any particular response. I am in favor, obviously, of reducing expenditures and getting the deficit down. But the President of the United States has to make a judgment on the national security posture of the United States, and that is an area where I do not feel any special competence. How they make those compromises is a matter of very important public policy for the administration and for the Nation, and I do not think that because you or I think it is desirable to have restraint on spending that that can override every other priority as well. I do not know what the facts are in the national security area, and I am very hesitant to pronounce a judgment on a particular area of expenditure.

Senator HART. I was not asking for a value judgment or a political judgment; I was asking for an economic judgment. If defense spending is increased and the next deficit is further exacerbated by the defense spending, what is the economic effect of that spending?

Mr. VOLCKER. Adverse.

IMPACT FROM CBO DEFICIT PROJECTIONS

Senator HART. What is your reaction to the projections this week of the Congressional Budget Office about the real projected deficit and what impact will that have on any chance of recovery later this year?

Mr. VOLCKER. Those projections were not surprising to me because they are in the general area of what I have thought was probable, and I think they are in the general area of what the

market thinks is probable, so I would not expect any particular impact from those estimates.

ALTERNATIVE ANTI-INFLATIONARY POLICY FOR TIGHT MONEY

Senator HART. Mr. Volcker, as an economist do you believe there is any alternative anti-inflationary policy that the Government or the Congress could adopt or should adopt besides tight money?

Mr. VOLCKER. There are policies that could be adopted complementary to what you call "tight money." I do not think tight money in this sense is synonymous with high interest rates at all, but I do not think you will have a successful inflationary policy over time without restraining growth in the money supply as one element in that policy.

Could that be complemented with other policies, consistent with lower interest rates and with better economic performance and all the rest? I think the answer to that is yes.

INCOMES POLICY

Senator HART. What are those other policy stances?

Mr. VOLCKER. I think one is in the fiscal policy area which we have been discussing this morning, but there are many other elements of policy that pertain to the structure of the economy, the competitiveness of the economy. There is the area of "incomes policy." I do not think it is very promising in the sense of laying down guidelines and not promising at all in terms of control; but if you ask me whether we have an ideal structure of wage bargaining in this country, the way it has grown up over the years and from the standpoint of reconciling price stability with prosperity, I do not think we do. I think there are perhaps lessons to be learned from the way other countries handle this particular area of policy.

Senator HART. Do you think that in the long term we can be successful in holding inflation down without some incomes policy?

Mr. VOLCKER. I think we can be successful without an incomes policy, if you interpret incomes policy as some kind of specific guidelines. I think it would be of help if there were some mechanism for forming a national consensus, if you will, as to what is feasible and possible and desirable, which could in turn work its way into the individual bargaining table negotiations a little more effectively than it does. There are institutional arrangements—and it is hard to judge just how important they are in the total picture—in both Japan and Germany that somehow seem to work better than ours. It is hard to make a judgment, first of all, on what contribution they make to performance; second, those arrangements arise out of a particular culture and history, and our culture and history are different.

I do not think we can import those arrangments directly, but it is suggestive of a different kind of environment that I would like to see talked about and encouraged.

Senator HART. Is it not the case in reviewing the performance of the economy in this administration over the past 18 months that a fiscal policy which was predictably expansionary and inflationary was offset by monetary policy which was extremely restrictive and predictably recessionary?

Mr. VOLCKER. I do not know whether it was extremely restrictive. I think that a rising budget deficit, at least in the face of restrained monetary policy, leads to more pressures on financial markets than you otherwise would have and to complications you otherwise would not have. In that sense, I agree with you, without adopting some of your adjectives.

Chairman DOMENICI. Senator Biden?

ECONOMY A YEAR FROM NOW

Senator BIDEN. Let me begin with a premise that both Democrats and Republicans are stupid. Senator Boschwitz is right and Senator Riegle is right. President Carter did not know what he was doing and President Reagan does not know what he is doing. Let us not talk about who is at fault for why we are here. We are in trouble.

My first question is, What happens if we are sitting here a year from now and unemployment is still as high as it is, interest rates are still as high as they are, the deficits are still in the $150 billion range and predicted to continue that way and business failures are continuing at the rate we are at, and there has been nothing other than a momentary, temporary economic upswing which has been swallowed up in the first quarter of next year?

What do we do then?

Mr. VOLCKER. I am not going to hypothesize about what you would do then. That is not my particular economic forecast. But it obviously would raise even more questions than you have now. You and everybody else, for understandable reasons, are talking about the troubles in the economy, and I would be the last to deny that the economy has troubles. But I also think that I can see things going on in the economy that are going to lay a foundation for a much better future and not a much worse one. This is a very troublesome period.

Senator BIDEN. When are we going to start seeing that?

Mr. VOLCKER. In some respects we see it now. You see the progress on inflation. I think you can see signs of progress on the productivity front, which is extremely important both for the sustainability of any recovery and for the economy over a longer period of time, if we can maintain that progress.

In terms of actual economic recovery, it continues to be our feeling that we are going to see that, but not at any breakneck speed, during the second half of the year.

Senator BIDEN. If things are the way they are now, next year, stagnant as they are, without putting any other adjective on it than that, would it be fair to say that the program put in place in 1980 requires some course correction or would you be saying then let's—in other words, how long do we have to wait?

Mr. VOLCKER. I think we make course corrections all the time. I just do not want to put myself forward in any detailed way as to what I would do a year from now; neither you nor I know what it is going to look like. But suppose we were sitting here a year from now. Unemployment will probably still be high, given what is happening now and given that I do not expect a highly rapid recovery. Suppose we are on a recovery path; suppose interest rates are significantly lower; suppose that you have made further progress on

deficits. We might be feeling pretty good that the prospects are for continuing, sustained recovery, maybe at a somewhat more rapid pace as time passes, and we might feel we have quite a solid foundation for looking forward.

Chairman DOMENICI. Would the Senator yield for an inquiry? Some of the Senators want to go vote and return.

Mr. Volcker, we did not have an outside time. What is your schedule?

Mr. VOLCKER. My schedule is your schedule this morning.

Chairman DOMENICI. We will have another round if Senators are interested. You can vote and return.

Excuse me for interrupting.

Senator BIDEN. The only point I am trying to make, if things are looking good, even if they are just mild continued optimism, then I think we should be staying where we are. I am all for giving the President a shot at his economic program here. That is where we are. That is where the votes are. That is what we are doing and let us hope it works.

Mr. VOLCKER. If that is not the case, you obviously have to look at all programs.

BANKS MAY START FORECLOSING

Senator BIDEN. Let me ask you another question.

What is the effect—let me put it another way.

Yesterday, some of us heard from an economist whose credentials I guess are slightly questioned because he has been embraced by many of my Democratic colleagues, just as some of the credentials of some economists have been questioned that have been embraced by the Republicans. But Mr. Thorow made an interesting statement and I do not know whether it is true or not and I would like you to comment on it.

He said there are a significant number of businessmen and women in this country who are banking on a recovery this fall that will allow them to not only hang on but stay on, that there are significant numbers of lenders who are banking on that recovery and, therefore, carrying a significant number of debtors now in the hope that it is going to improve.

But if it does not come in the next quarter, if it is as it has been, without casting aspersions—we were not very good at it in the Carter administration—the predictions have not been very accurate, if the predictions turn out to be what it was for this quarter and the last year and the quarter before and it does not come forward, he says that he believes a lot of banks are going to start foreclosing on the old homestead, start to foreclose on businesses, and that we will begin to see a very—a crisis proportion in terms of the stability of this economy; that it will start to run.

Then he said—he noted, not making an exact analogy, he just threw in parenthetically that everyone was counting on a full recovery in 1931, in the third quarter. That is what everyone was banking on.

When it did not come, that is when everyone started to pull the plug.

Is there any reason to believe that is a prospect?

Mr. VOLCKER. I am not a believer in the precipice theory.

Senator BIDEN. I would not call it a precipice theory.

Are there a lot of banks just hanging on with debtors, letting them continue on just one more quarter? Are they sitting there—you know these guys.

Mr. VOLCKER. Problems can accumulate. But saying they are going to hang on for one more quarter and then pull down the shutter I think overly dramatizes the situation. They are in the process of continual evaluation, and what they do next quarter will depend on what their expectation is for the following quarter.

Senator BIDEN. I am just from a little State that is fairly unsophisticated. But bankers in my State—and they are not big New York banks—they are doing just what I said. They are telling businessmen, look, you got one more quarter. They are making that judgment now. They are not going to wait until next quarter. They are giving them advance notice. They are saying, unless it turns up, I cannot hang with you.

Now, we are little and unsophisticated. But I suspect the others are doing similar things, aren't they?

Mr. VOLCKER. I suppose a banker will always do that to some extent.

Senator BIDEN. But don't you think he might mean it?

Mr. VOLCKER. I do not suggest they do not ever mean it. There are more of these cases now than at other times, but you want me to take a position on the proposition that the whole world turns upon what happens in September.

Senator BIDEN. Chairman Volcker, you are good enough to be in the State Department, the way you avoid answering. I am not trying—I just said is that an outrageous theory.

Mr. VOLCKER. I am trying to give you the best answer I can.

Senator BIDEN. You do not think that is a probable scenario?

Mr. VOLCKER. I interpret your question as implying that at some point something will happen and we are going to fall off the cliff. I do not think that is a probable scenario.

Senator BIDEN. I surrender.

FISCAL YEAR 1983 DEFICIT ATTRIBUTABLE TO SHORTFALL IN REVENUE

Chairman DOMENICI. I accept.

Mr. Volcker, I am going to ask a few questions until they return. I am sorry I have my second round when some of them are not here, but I am sure they know what I am going to say.

A lot of the criticism of the budget resolution, it is amazing.

If I read your statement correctly, you are saying, we better do at least what is in there now.

Do I read you right?

Mr. VOLCKER. Yes.

Chairman DOMENICI. My good friend talks about revenue hemorrhage in the third quarter. But I am not asking you this year. Senator Dole and his Finance Committee and the U.S. Senate just changed the tax laws. If I read it correctly, they raised more revenue than if we got rid of the third year on the tax cut. My numbers would indicate the rescinding the third year cut would rise $32 billion in 1984 and $34 billion in 1985. The Finance Committee raised

$43 billion and a little bonus of $21 billion in 1983 on deficit reduction by revenue raising

So I do not know that that issue is so significant. There has been a change in the policy. About 25 percent of the tax cut has been taken back. There are many who think the cut was too big. I do not know how much it was too big by. But 25 percent has been recaptured in the tax bill, if the House passes this or something like that. I just got some figures on some other things we have around here. Forget 1981 where there was an effective $37 billion reinstatement in 1982, but for the President's statement on lifting the military spending lid, which may be real. Congress in the 1982 Budget Resolution has a 3-year restraint of $125 billion over what it would otherwise be. All of it is in reconciliation or appropriations which this President can control, and then we add to that $98 billion in revenue.

Now, Mr. Volcker, do I read your statement right when you say that whatever the real deficit for 1983 is, that most of it is attributable to shortfall in revenue because of deflation and we are not going to grow as fast as estimated? That is Mrs. Rivlin's testimony, and I assume from your statement——

Mr. VOLCKER. Compared to what? You are saying most of the deficit is——

DEFLATION CAUSING REVENUE SHORTFALL

Chairman DOMENICI. Compared to the 104.

Mr. VOLCKER. Compared to the $104 billion figure, probably most of it can be attributed to that; yes.

Chairman DOMENICI. And you say in your statement, if I read you right, that we ought not be worried about that from the standpoint of your money policies—

Mr. VOLCKER. Correct.

Chairman DOMENICI. Because that is deflation.

Mr. VOLCKER. Lower inflation, correct.

Chairman DOMENICI. Which you think is good, which is causing us to gain less revenues.

Mr. VOLCKER. Let me, if I may, just supplement that point with reference to Senator Biden's comments. That deficit creates a big problem, particularly when you look into the outyears. But I think it is also true that that deficit in the short run is pumping a lot of purchasing power in the economy which diminishes the risk of the kind of event that he may be foreseeing.

RECONCILIATION INSTRUCTION BECOMES CONGRESSIONAL CHALLENGE

Chairman DOMENICI. I want to make this point and then ask you a question.

It also seems to me that there are a lot of people who do not have to be on the side of carrying out any policy, and I do not mean every Senator on this side, because some have voted for very tough things, but I think the challenge is whether the Senate will carry out the reconciliation instruction and the absolute challenge is whether the U.S. House of Representatives will. That is a pretty significant deficit reduction that is contemplated in that resolution. I do not think they really intend to carry it out.

Mr. VOLCKER. I agree, that is the immediate challenge, and apart from its immediate impact on spending and on the deficit, which is not unimportant, it will be looked at as a token of what Congress is prepared to do in the future.

RELAXING MONETARY POLICIES

Chairman DOMENICI. Mr. Volcker, you seem to be telling us that you do not have a lot to do with interest rates. I think you do, and I think the Federal Reserve System has a lot to do with interest rates.

Now, if I read you correctly, you are saying that the Chairman of the Federal Reserve cannot publicly announce that there will be looser money policies in this country because there is a fear that that will have an adverse effect rather than a salutory effect. I do not want you to answer that. I have heard that from so many experts and former chairmen that I believe that is a trepidation that you are operating under.

However, I want to make this point:

There is no way that this Congress can do substantially more than what is reflected in this budget resolution this year.

Mr. VOLCKER. I do not disagree with that.

Chairman DOMENICI. Second, we cannot wait for interest rates to come down until we have delivered on the entire package of fiscal restraint. This installment, if carried out, has to be accepted by you, your board, and others as a genuine first step moving toward sound fiscal restraint. If you do not accept it as such, there is no way that we will get out of the catch 22. It is impossible. We lose more revenue than we possibly can restrain through fiscal policy. The politics of it are that it is going to get so bad we would not get anything better.

I do not expect an answer from you. I just wanted to make a point. I read your statement as being your subtle way of saying we will probably loosen up on our monetary policies when you say "the committee considered the possibility," et cetera, and said "growth of aggregates somewhat above the targeted range would be tolerated for a time consistent with the general policy thrust."

I commend you for that. I read into it a genuine concern about the recession and I hope it means what I think it means.

Mr. VOLCKER. I think I had better comment, because lack of comment might be taken as a comment.

Chairman DOMENICI. I am going to miss the boat. I will be right back.

[Recess from 11:46 to 11:55.]

Senator BOSCHWITZ [presiding]. Mr. Chairman, we are going to go back into session and the distinguished minority leader of our committee wishes to question you.

GOOD CHANCE INTEREST RATES WILL DROP

Senator HOLLINGS. I guess that the coverage of this session would be headlined that Chairman Volcker was hopeful. You can tell in contrast that members of the committee, in their questioning, whether it was Senator Andrews just a minute ago or earlier Senator Quayle talking about survival and others talking about going

98-044 O - 82 -- 6

over the precipice—I take it from your testimony, just the general tenor of it and the answers given, that there is no question that we are going to see lower interest rates—that the program at the Federal Reserve is working, that we are not, as you see it, at a precipice or at a real dangerous situation in the next 3 to 4 months.

Is that the proper impression? I feel a little bit better because I do listen to the business leadership and they have a different view.

Mr. VOLCKER. I think in general you characterize my responses accurately. I did not go so far as to say that there is no question about the interest-rate outlook; I think there is obviously a question. I suggested that I thought there was a good chance that interest rates will go down. I do not see a precipice, but there are risks; there are difficulties. Can I tell you conclusively that there is going to be a recovery of x percent? No, I cannot.

FEDERAL RESERVE POLICY PRIOR TO 1979

Senator HOLLINGS. I want to fix the policy of the Federal Reserve prior to 1979. I want to preface that—all Senators take too long in prefacing their questions. But we should have done better at the congressional level, and I feel very strongly that perhaps having run the course, fought the fight, and we ended up as we had with even larger deficits—I rather dissent from your idea that it is better than it would have been. I happen to feel very keenly that the Democrats would not have allowed a $140 billion deficit. If Hubert Humphrey would have been elected, he could not have dared a trip to Red China, whereas, Richard Nixon could have pulled that off. Where a Democrat could not have dared a $140 billion deficit—then Republicans say it is only a certain percent of the GNP.

I underscore that with the observation about President Carter and a lameduck Democratic Congress passing the first reconciliation bill, $8 billion spending cut in December of 1980, after we had been defeated and sent home.

But in any event, I think one has to come back after the election perhaps and not let these bankruptcies ensue, unemployment continue to grow. But in the meantime, you can see what the attack is. The Republicans are going after the Constitution. The Democrats are going after the Federal Reserve and the Democratic thrust is simply this.

Prior to October 1979, the Federal Reserve targeted interest rates rather than monetary growth. You say we asked for that. Let us assume we did ask for that and we are to blame. But, in any event, it worked good for, say, Dr Arthur Burns, to target the interest rates.

FIX FEDERAL FUNDS RATE

What is the matter with a bill that would state categorically, since a 3-percent return on investment money over and above inflation is considered good, what is the matter with saying that the Federal funds rate be kept at a level between 1 and 3 percent above the rate of inflation and pass that law as a matter of policy?

Would you criticize that or approve it?

Mr. VOLCKER. We probably could not carry it out. In the interest of historical clarification, I think there is a lot of confusion about what we were doing before October of 1979. I alluded to it earlier. Before October 1979, we were targeting monetary aggregates, not interest rates, in a broader sense. We were using, as an operating instrument—as an operating variable from week to week—particular levels of the Federal funds rate. Those instruments were changed and the interest rates changed as judgments were made about what was necessary to reach a certain monetary aggregate. So the change is perhaps less fundamental than you imply.

I think what perhaps did change in a more significant way after 1979—one of the reasons we made that change then—was perhaps to put additional weight, additional intensity on the necessity of being within the monetary target ranges against a pattern of having exceeded them for some period of time and, more importantly, in a period of accumulating, accelerating inflationary pressures.

In other words, the previous policy did not appear successful in its fundamental objective of dealing with the inflationary problem which to this day underlies many of the problems that you have been emphasizing. It is certainly not correct to say that we were targeting real interest rates before 1979; we were not.

Senator HOLLINGS. So then answer the question or elaborate. You said it could not work.

Suppose we had passed a law, passed through the Congress, three readings, that we fix, as a matter of policy, fix the Federal funds, rate at anywhere between 1 and 3 percent above inflation.

Mr. VOLCKER. You would have to tell us how to define inflation.

Senator HOLLINGS. Let us assume we could tell that.

Mr. VOLCKER. That is a big assumption.

Senator HOLLINGS. That would be difficult.

Mr. VOLCKER. I suppose it is not too difficult, but if you look at the Consumer Price Index for the last 2 months, inflation has been at an annual rate of about 12 percent. In the previous 4 months it was at an annual rate of about 1 percent. I do not know whether that implies the Federal funds rate should be 13 to 15 percent in July and 2 to 5 percent in April. There are substantial problems of definition, at the very least, which illustrate the problem with the real interest-rate concept. Now it could be argued that inflation expectations are more stable than actual inflation, so we should use expectations, but then how do you get a direct measure of expectations that's reliable for this purpose?

But even more fundamentally than that, it implies that we know what the real interest rate should be and we can control that real interest rate even on Federal funds consistent with much more fundamental economic objectives. We are interested, in the end, in the performance of the economy; we are interested in growth; we are interested in inflation. I cannot give you what I would consider sound professional advice about precisely what Federal funds rate is consistent with those objectives over a period of time.

I am strongly of the view that what is consistent with those objectives over time will vary substantially over time. If there is any interest rate we can control in the short run it is the Federal funds rate, but I cannot tell you at what expense to other objectives over

a period of time—that is, what you would have to do to achieve that control and what other economic problems that would create.

POSSIBLE ECONOMIC PROBLEMS

Senator HOLLINGS. That is what I am trying to get at. What economic problems would be caused? Let us assume, other than the mechanical differences and we could even it out, that what we would have along with the inflation rate now of around 6 percent, is a proposal to the effect, Mr. Chairman—the question is suppose the Congress enacted a statute requiring the Federal Reserve Board to maintain a Federal funds rate at a range between 1 and 3 percent above inflation. That is considered by investment people—that 3-percent return above inflation is good. You do not see anything economically wrong with that. That is a good return. You know you got an economically sound return. Then what is wrong economically with doing it? What happens, wrong or right?

Mr. VOLCKER. Any number of things could be wrong. It depends on what else is going on in the economy, essentially. Let me give you several kinds of examples. I can imagine circumstances where, at least in the short run—the short run could be a period of time very preoccupying to the U.S. Congress—a real Federal funds rate in that range might be inappropriate to the economic circumstances; you may want to see a lower one.

Or suppose you have very high inflation, and it was continuing with the Federal funds rate mechanically calculated the way you have calculated it—slightly above the inflation rate. Suppose the inflation rate is very high and accelerating.

And you have a substantial tax impact. Are you talking about a nominal interest rate? What is the real interest rate after taxes? It may be hugely negative. You might find the interest rate is much too low to be consistent with an effective inflationary program. I do not know.

Senator HOLLINGS. But to a lame mind like mine, we know the inflation rate never got above, let's say, 14 percent. So if I had a Federal fund rate of 1 to 3 percent above the inflation rate, that would be, at the top level, 17 percent and that is about at the margin where we are now, whereas, if we went to the very—the inflation rate of 6 percent at the moment and had a Federal fund rate of 3 percent over that, around 9 percent, 9 or 10 percent——

Mr. VOLCKER. We are not very far from that.

EASING OF MONEY SUPPLY

Senator HOLLINGS. That is right.

Wouldn't that be a salutory development, helping the economy in the right direction? I think the frustrations and there are a lot of considerations to your trained mind. But explain a little bit better to my untrained mind.

Would it be easing the money supply? Could somebody say that and why?

Mr. VOLCKER. It would probably, right now, require an easing of the money supply. I do not know how big. We are not all that far from the particular level you picked out at the moment. But suppose it did require a very large easing of the money supply to

achieve that objective at the moment. And suppose the net result of that was to send up long-term rates? Would you be happy or sad?

Senator HOLLINGS. How could they send up long-term interest rates?

Mr. VOLCKER. Because people could say the money supply is increasing much too rapidly. My conclusion, if I am sitting in the market, if I am a businessman, may be that I can see nothing come out of this but a higher rate of inflation. If I am an investor, if I am running a pension fund and I have a lot of liquidity, the last thing I want to do is buy a long-term bond when I see the money supply accelerating at that rate of speed.

STABILITY IN INTEREST RATES

Senator HOLLINGS. That assumes we do not have any problems right now. The fact of the matter is we have been targeting. Wouldn't it be better if everyone could count on some stability in interest rates, at most it would be 3 percent above inflation, and at least around 1 percent. So you would have some flexibility but it could never get to the extreme.

Mr. VOLCKER. I think a lot of people probably did count on real interest rates never being so high or growing because that was the historical experience. And I think, quite frankly, that was part of the process during the 1970's and before that got us into the very problem we are in now, that that expectation was kind of firmly implanted. People felt, for instance, that they could extend their borrowing beyond what they had earlier, beyond most historical experience. They said, "We can borrow a lot of short-term debt We do not have to increase our equity. We do not have to worry about our long-term position because interest rates will never go that high." They got their balance sheets extended and they got in a jam.

You can try to support that behavior forever, but I would suggest to you it is impossible, that sooner or later there are limits on that kind of behavior. I cannot identify them down to the year, but I know that we were on a course that was unsustainable.

Senator HOLLINGS. Very good. I appreciate the comment and the chairman's indulgence. There are responsible economists that testify that that is a good approach. I wanted your comment.

Mr. VOLCKER. There are a lot of good economists that are testifying that a lot of things are good approaches.

Chairman DOMENICI. You heard my story about the 12 economists in the Soviet May Day Parade. They were all dressed in black with gray hair and they all held hands. Brezhnev looked over to his friends and said, "Who are they; are they spies?" The friends said, "They are economists; think of the havoc they will wreak on America when we turn them loose over there."

Now, I did not finish my question.

Mr. VOLCKER. I did not finish my comment.

REVENUE RAISING OPPORTUNITY

Chairman DOMENICI. Could I repeat this because I told my friend from Michigan these numbers when I was coming in.

You know, everybody is saying, "lower the deficits, the tax cuts were too big," and I said, in his absence, I did not know how much they were too big by, but that if my numbers people were right, that you would hue and cry that the third year should never have been passed and get rid of it.

My numbers say if we got rid of the third year, in 1984 that would be $32 billion; in 1985, $35 billion. Bob Dole in the Finance Committee and the U.S. Senate raised $21 billion in 1983, but in 1984, $34 billion and in 1985, $43 billion, for a total of $98 billion in revenue to apply against the deficit versus $74 billion if one were to get rid of the third year tax cut. So it seems that a real opportunity was given to those who said that we should raise some revenue—to vote for that or to have an alternative like it that had a chance of passing.

Now, in addition, but for the military, which I said we may have to have a discussion with the White House about, the targeted reduction in that function over the next 3 years is $42 billion, to my recollection. We expected to reduce it by, as everyone else did, $125 billion, reconciliation, and targeted appropriation. I think that is a pretty whopping big reduction and I think you agreed with me that that was the first thing we ought to get done in the absence of the Senator from Michigan. Then I left you with the question of what did you really mean in your statement.

EASING AND TIGHTENING FORUMS

Mr. VOLCKER. In connection with the comments you made on what we meant by our statement, let me give you my bottom line right off the bat: I would understandably, I think, prefer to let the words that I have in this statement and the words I have in the statement before the Banking Committee convey precisely what we had in mind. I am not sure that I am going to improve upon that version. We talk in these forums about easing and tightening. I think we get into great semantic difficulty. Different people have different things in mind when they talk about easing and tightening. In some sense, yes, some things have certainly been easier in the market; there have been less pressures on bank reserve positions.

Pure monetarists could say things were a little tighter. A market man says they are easier. I would not try to reconcile that. I will let my words speak for themselves.

There are a couple of other points I wanted to mention. There was some implication, indeed by Senator Hollings, that somehow the Federal Reserve sees itself in a negotiating position, that somehow we are holding out for Congress to do something else. That is not the way I conceive our position at all. We attempt to describe the budgetary picture. We think it has some problems, but we have to take it as given. I agree with your comment as to the value of what you have done. I basically do not expect anything very dramatic to happen in the next few months, for the reasons that you suggested, but we are not maneuvering policy with an attempt to have an impact on what you do.

To the extent we try to have an impact on what you do, it is by my statements to you and not by our policies. I want to make that very clear.

NO CONTROL OVER INTEREST RATES

With respect to interest rates, again, we get to that old problem. I would love to see the high rates disappear, I would love to see them lower, but I do not think we have the control over interest rates that your comments imply. The most fundamental influence we can have over interest rates over time, which is profound, is our ability to influence the inflation rate.

That is not going to be any short-run influence. I think now we can have some influence over the short-term rate for a short period of time. The question is how that can be used in a way that is going to produce a constructive result over a period of time. You are not really going to care, in the end, whether we did something dramatic that produced an immediate response in short-term rates for a few weeks but in so doing somehow maximize the changes of a quick rebound in rates, with more confusion and more difficulty in the financial market. That is not going to help anybody.

We have to continue to try to deal with policy in a way that is going to have a constructive effect over a period of time, and that is the judgment we try to make.

SERIOUS PROBLEMS RELATE TO OUR INABILITY TO GROW

Chairman DOMENICI. Mr. Chairman, I think you are a very intelligent man. You have been good at this. You have been through a 2-hour, shortly to be 3-hour, series of questions. You have listened to all kinds of statements. You must conclude, based upon the political statements made here today, and there have been plenty of those, and considering the economic statements and the questions, that there are some serious problems out there in the hinterland that they do relate to our inability to grow which, in turn, people say is based upon high interest rates.

Now, if nothing else, you leave with that today, and to the extent that you have anything to do with it, it would seem to me that you cannot—if you can ameliorate in any way, you cannot wait for us to do more.

At the very least you can say, let us see if the House cuts the budget beyond that.

Mr. VOLCKER. We are not waiting for you to do anything. We encourage you to do all you can. We would like you to move further, but we are not waiting in terms of policy for you to take additional actions.

I would only add to your comment of what one carries away from these sessions. I think what you said is an accurate reflection of what is on many people's minds, including our own. But there is another side to the story which is that in some very fundamental ways we are on the way to correcting the problems that developed over a long series of years, culminating in this very difficult situation. I think it is an illusion to think that the economy could have gone along the way it was going in the 1970's with happy results. I think there are things that are going on now that are, despite all

this trial and trouble, promising for the future. I do not want to leave this on a totally negative note.

INTEREST RATES NOT EXPECTED TO HIT NEW HIGHS

Chairman DOMENICI. I have two other quick questions. One has to do with Henry Kaufman. Since he makes a lot of money being Henry Kaufman, the prophet of gloom. I have a name for that in Spanish. When my father had his little grocery store, when the man came around with the bicycle bringing back the bad checks, he would point out to the man and call the little fellow the—Spanish expression—which means the bird or bearer of bad news. That appears to me to be what Mr. Kaufman gets paid for.

So I would like to ask you this question, since, if you answer it right, a whole bunch of investors will get your advice free.

He and others believe that interest rates will hit record highs later this year.

Do you believe this will happen or not?

Mr. VOLCKER. No. I have indicated that I think the probabilities are that interest rates could go in the other direction. For all the uncertainties in the situation, I do not expect to reach new highs in the second half of this year.

ROLE OF MONEY MARKET CERTIFICATES

Chairman DOMENICI. Now, my last question—perhaps you can submit the answer—I do not understand the role of money market certificates in our banking system. I thought for a while it was just sort of a temporary fluke that we ought to leave around, the money market idea out there. They are not banks. They do not have reserves. Their investors are not protected. But now they are writing checks. I do not understand whether they are healthy or unhealthy in terms of our attempts to get interest under control. And it is not primarily my jurisdiction, but the more I hear about them the more I wonder.

Is it appropriate for you to answer that later in the record with an analysis?

Mr. VOLCKER. I can give you a brief answer now. I am not going to point the finger at money market funds as having a primary influence on the level of interest rates in the economy. But if you ask me whether that development is structurally, or institutionally a particularly desirable development, I do not think that it is. We have an elaborate structure of banking regulation which adds to banking cost. These funds have grown up outside the established system, and I think considerations of equity, monetary policy, and financial structure suggest that it is not only a useful question to ask but a useful question to pursue as to what the structure of regulation in that industry should be.

Chairman DOMENICI. The reason I asked the question—you know, Mr Chairman, I do not understand all that banking finance, but I understand this. We will be back on the right track when advertisements about investing money or borrowing money, come down as a percentage of the commercial advertising market; then this Senator will assume we are on the way to recovery.

It seems to me the principal commerce in this country is borrowing and investing money for money's sake and I do not understand why there is so much of that. Wholesale, retail, secondary—and that just seems a little bit haywire.

Mr. VOLCKER. I happen to share that view very much, that we have become preoccupied with this pursuit, probably because real investment has not been all that profitable.

Chairman DOMENICI. Conversely, that kind of investment is very profitable.

Mr. VOLCKER. I do not know that that kind of investment has become profitable, but I know a lot of speculative and semispeculative activities have appeared more appealing, and I think that is a sign of ill health rather than health.

Chairman DOMENICI. Senator Riegle?

FEDERAL RESERVE NOT COMPLETELY POWERLESS

Senator RIEGLE. These 5 minutes do not allow for much continuity. But I want to get back to a question I asked before.

In my State we have over 750,000 people unemployed. Increasing numbers have exhausted their unemployment benefits. The State has had unemployment above 10 percent for 32 consecutive months, just to give you an idea of how severe the problem is.

The State economically is bleeding to death and the rest of the country is not far behind. So when those of us who are here suggest other possible ways of conducting monetary policy, we are not asking you to open the flood gates. I hope we would not be understood to that extent. We are not asking you to wave a wand. There are different ways. As a matter of fact, you made a change in policy when you made a decision to lower the discount rate by half a point. That was an objective decision that was made by yourself and others in a group. It was not a matter of the window being opened and a fly coming in and saying it will now be a half point lower. You made that decision as a matter of policy.

As a result, what has happened is that the prime rate has dropped since that time. Now, one can argue about the cause-and-effect relationship here. But, nevertheless, you took one step and we saw shortly thereafter a reduction in the prime rate by a number of banks in the country. So I think that is a measure of the fact that you are not completely powerless in terms of walking in here and saying there is really nothing we can do.

DEFICITS OUT OF CONTROL

Starting from there, and the fact that I have said before in other meetings that we have had, and other appearances—I think we need an emergency Budget Committee meeting. The President ought to convene a summit. Members of both parties ought to participate. You ought to participate. We ought to reduce the deficit. But that is not happening. The administration has made the decision to stand pat through the remainder of the year. That is now well publicized in magazines and newspaper articles and, as a matter of fact, in the New York Times piece, it says they have decided to take off the lid on defense spending so that in fact the deficits will get even bigger.

What does it all mean? It means the fiscal situation will not improve. That is what Alice Rivlin was saying yesterday. The deficits are out of control. If one looks at the tax bill that comes out, that is assumed in those numbers. It still leaves us with deficits of $150 billion plus.

NO TIME FOR FISCAL POLICY ADJUSTMENTS

Congress is about to shut down. We have about 40 working days left. There is not going to be an effort to substantially alter the fiscal picture. Once the Congress shuts down, it is not clear whether there will be a postelection session. I do not know if there will be. It will be the first part of the next year before we are up and able as an entire Government to really make major adjustments in fiscal policy.

What this does, in light of those facts, and those are neutral facts, just an analysis of what is going to happen, is that it leaves the Fed in the situation of maybe being the only principal player that has any appreciable degree of operating latitude during this intervening period while the Congress is in the process of shutting down and out of session. Even the President with the Credit Control Act expiring does not have certain emergency powers he had before.

You testified that you see Federal borrowing being $50 billion in this quarter and $50 billion next quarter. That is $100 billion. Everybody that I have talked to seems to feel that if we are going to have that kind of borrowing requirement and some kind of fairly anemic recovery, with the overhang of the deficits that Alice Rivlin was talking about yesterday, we are not going to get a sustained recovery. We will limp along and the likelihood is that even though we saw some easing of interest rates, that that is likely to stop and in fact maybe even go higher. Maybe not as much as Henry Kaufman says, but somewhat higher than they are now.

TIME TO CONSIDER CHANGES IN POLICY

I want to make the most serious appeal to you, because a lot of time has run now and you are getting down to the situation where the damage to the economy and the structure of the economy is severe enough that I think you do have to consider some changes in policy, part of which I think you have already done which the discount rate reflects.

Why you took it down a half point instead of a full point—when you might take it down a full point from this point, I do not know But these are important questions and I think you are going to have to focus on those before long, or we are likely to find ourselves with a lot more damage on our hands.

I hear too many well-managed companies say to me they cannot last much longer, given the interest-rate picture we have.

You know as well as I do, there are an awful lot of companies that are staying alive by means of short-term rates. So the higher those are, the more you are bleeding them dry rather than helping them weather the storm and stay around for long-term investment later.

MONETARY POLICY ALTERNATIVES

I would like to make another suggestion.

Why wouldn't it make sense for the Federal Reserve to bring together some of the senior people in the private sector, business firms and private sector, that would function like the old Committee on Interest and Dividends we had back in the 1970's, that would be charged with a mandate to help you and the Fed think about specific alternatives that might get interest rates down and would help rectify other major sectors of the economy?

Why would not that be a useful and neutral step that might let you draw on some counsel in an organized fashion, that would let you look at what other monetary policy alternatives might be available to us given these other factors that I have cited?

Mr. VOLCKER. We do have a good many contacts of the kind you cite. It is hard to argue one way or the other, but experience shows that is not very successful unless you have something very specific you want to come out of that that you think is practical and doable; otherewise you raise unwarranted expectations that there may be some solution that no one has thought of.

Senator RIEGLE. But it does not hurt us, it seems to me, to look for it.

Mr. VOLCKER. I would suggest that we look for it all the time.

Senator RIEGLE. I am talking about in an organized, institutional fashion, by drawing in some senior privatesector people who can be part of this thought process in a systematic way and the reason I think it is so important is not only that we are moving into an emergency situation in the economy, but everything I can see tells me that the economic problem of today is not the same as the one we had in the 1970's or any other time period. It is much tougher.

We are in a world economy. There are enormous structural problems taking place and we may have to invent some new tools. It may be that the established list of policy options and policy tools is not sufficient. We may have to invent our way to new answers because we are faced with a whole new set of world realities

What is the harm in doing that?

Mr. VOLCKER. I think the problems are in some way unique; they are certainly worldwide, more difficult and certainly different than we had before. Suppose you wanted to look at some different policy areas. I mentioned to Senator Hart earlier some other areas outside of monetary and fiscal policy as well. The question still remains as to whether it is useful to get together a group that has some random characteristics, I suppose, and discuss, in a self-conscious way, with a clean sheet of paper, some new policies. I do not think that is the most productive way to proceed.

CREDIBILITY OF FED DIMINISHING

Senator RIEGLE. I hope you will think about that because the credibility of the Fed is diminishing, deservedly or not. It is apparent in conversations around Congress from both parties, people talking about changes in structure, changes in policy. Across the country I can take you into any community in my State; there is great question about the soundness of Fed policy, and I think it is time to maybe broaden out some and involve some other people in

thinking about this problem and what might be prove to be a better answer.

Mr Volcker. I do not know what you find going around the country; you report what you find and I take that as a given. But I do not want the record to stand as suggesting that that confirms the impressions of Federal Reserve policy from the business or financial community. There are obviously many questions in a period of this sort, but I do not agree with your general characteristization. Maybe I get a very biased view.

Senator RIEGLE. I think a tendency is for you to get a biased view. I think people may be reluctant to be quite as blunt in their conversations as they may be when we are talking about the Fed when you are not present. You and I have had a long-standing positive relationship and I want to continue that. But I will tell you this, that there has been an enormous amount of people from financial institution presidents to people running businesses on Main Street that are losing their confidence in the ability of all our institutions, including the Federal Reserve System.

Mr. VOLCKER. That is a somewhat different question and a different way of putting it. A lot of people out there are uncertain, concerned, and frustrated.

Senator RIEGLE. Time is running out and if you do not see that and find a way to do something other than what you have been doing, I think you will find that you are lagging way behind events and that would be a disservice to the Fed and to the country.

PEOPLE BLAME CONGRESS

Chairman DOMENICI. Permit me an observation.

If we are talking about popularity, people are mad at Congress. They would like to get rid of us. Maybe they would like to get rid of us more than they would like to get rid of you. It seems to me it is a tossup in terms of who they blame. But, certainly, I agree with you, they blame Congress more than they blame the Federal Reserve Chairman. That is my approach. But I am not running now.

Senator RIEGLE. It is not a question of laying blame. That is totally beside the point. What the public wants are policies that work. We have policies that are not working and, therefore, they need to change. Why can't that be a neutral observation? That does not have to have a partisan slant.

Chairman DOMENICI. I was not saying partisan blame. I did not say "Democrat." I said Congress.

Senator Exon?

BANKING LEGISLATION

Senator EXON. Thank you, Mr. Chairman.

Mr. Volcker, I will try to be brief.

There are two areas.

First, with regard to the banking legislation about to be reported out of the Banking Committee, I will phrase the question in a minute in that regard.

Second, about the second concurrent budget resolution of which very little has been said about here this morning—but I guess that was the reason for this meeting.

First, as the head of our central bank, how do you view the legislation about to be reported out of the Banking Committee? I am speaking specifically of the Garn bill and I am sure you are familiar with it.

How do you see that bill?

How will that bill affect the money market?

Is it necessary for us to go to the extent in your opinion that that bill goes to in addressing the problems, real or imaginative in certain sectors of our banking industry?

Mr. VOLCKER. I cannot comment in detail because I do not know what is in that bill in all its details. I have some surmises about things in the bill, but I do not know it in detail, particularly the so-called powers part.

Senator EXON. What about S. & L.'s becoming banks?

Mr. VOLCKER. Let me go through in order and get to that one.

That bill, I assume, will contain the elements of the so-called regulator's bill that we have been proposing and urging for some time. I suppose it will contain some capital infusion measures for S. & L.'s. I think those are both very important in the current situation and I would urge your sympathetic attention to those provisions.

On the structure side, I am much less certain about what will be in the bill. I have testified on this matter in some detail. I do not myself want to see legislation that simply broadens the powers of S. & L.'s indefinitely and gives them all the powers of commercial banks or goes beyond that, as is true in some versions.

I have indicated that some limited commercial loan powers in a proper framework—single borrower limits and so forth—are appropriate, and I would support limited changes in that respect. But I do not know just what the bill is going to provide.

There are also questions on the commercial banking side of additional powers in the securities area, some of which we have supported and some of which we have not. Again, I do not know what will be included in this bill.

Senator EXON. But the overall intent of what you understand that legislation to be would be, given some reassurances to the overall financial stability of our banking system today——

Mr. VOLCKER. The parts that are relevant to the stability of our banking and thrift system today are the so-called regulators' bill and the capital infusion part; and, yes, I do very much support those parts of the bill.

SECOND CONCURRENT RESOLUTION

Senator EXON. My second question with regard to the first concurrent resolution on the budget—page 16, section 7, conference report on the first budget resolution (S. Conf. Rpt. 97-478), I would call your attention to the fact that section 7 says if the Congress has not completed action by October 1, 1982, on the concurrent resolution on the budget, it goes on to say that this concurrent resolution, meaning the one that we previously passed, called the first concurrent resolution, this concurrent resolution shall be deemed to be the concurrent resolution required to be reported under section 310(a). That means that we are bent on not having a second concurrent resolution but being stuck with the first.

I understand earlier you said the first concurrent resolution—I hope you did not mean that we should make no changes or we should not report out a second concurrent resolution, possibly to further cut expenditures, possibly to further increase revenues.

But certainly I would hope that you would agree that it would be in the interest of stability and understanding if we would at least, if nothing else, make changes in our first concurrent resolution to reflect the more accurate deficit figures that now seem to be generally agreed to by all parties.

Mr. VOLCKER. I think the thrust of my comment was that you carry through on the broad intent of that resolution, and make savings and carry forward on the tax bill. If you can do better, Godspeed.

Senator EXON. Wouldn't you agree that the only way we really can do better than that is to come out with a second concurrent resolution?

Mr. VOLCKER. I frankly am not that familiar with the procedures of Congress. But if you can do better than that in those respects, I certainly would not want anything I have said to stand in the way.

Senator EXON. Thank you, Mr. Chairman.

Chairman DOMENICI. Would the Senator direct that question to me?

Senator EXON. Yes. I redirect the question to the chairman of the committee.

Chairman DOMENICI. I assure you that if this committee finds that Congress carries out the intention on the cuts side and tax-raising side in both Houses, I will consider they are serious about doing something further. I would be surprised if they do that much.

I can tell you from my standpoint the only thing that is different in the resolution, based upon Dr. Rivlin's testimony—we have not heard the administration—are the assumptions. There is nothing wrong with the cut side. They are not saying if we cut where we said there will be anything different. I do not think I could recommend cutting more, which I understand by implication you would be interested in, to get the deficit down to where it is predicted even would change the economic assumptions.

Am I correct?

Senator EXON. You may be correct in your assumption, but I do not necessarily agree with your assumption. I believe that we are scheduled to come back after the election to make cuts. Is that true?

Chairman DOMENICI. I think there is a chance we will come back supposedly for social security and a few other things.

Senator EXON. What I am saying is if—it seems to me we may cause further violence and damage to the budget process if we do not have a second concurrent budget resolution, even if that means, Mr. Chairman, biting some rather hard bullets and making some decisions even before the election.

Chairman DOMENICI. Well, we will see if they make the first batch first.

[Whereupon, at 12:40 p.m., the committee adjourned.]

VIEWS OF THE OFFICE OF MANAGEMENT AND BUDGET

TUESDAY, AUGUST 3, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Andrews, Grassley, Kasten, Gorton, Hollings, Chiles, Metzenbaum, Riegle, Moynihan, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The hearing will please come to order.

I understand a number of Senators will be here before the morning ends.

We will follow our normal pattern, excepting for the ranking member. Upon his arrival, he will be recognized next on his side. But other than that, we will recognize as Senators arrive.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Mr. Stockman, it is a pleasure to welcome you to the committee this morning.

Our purpose, as you know, is to have you present us with an overview of the President's Mid-Session Budget Review and discuss with us the administration's budget policies in light of the economic outlook and the projected Federal deficits.

WEAKER AND SHORTER RECOVERY EXPECTED

The economy appears to be recovering only very slowly from a severe recession, as you are aware. Many economists, consequently, have revised their outlook for both the strength and the length of the expected recovery. Now they generally expect a weaker and shorter recovery than they predicted earlier, even though interest rates have declined sharply in the recent past. In fact, the rates now are lower than at any time in the last 2 years. This is a good and hopeful sign, but the cautious outlook of many economists indicate that it may not be sustainable.

The prevailing view of the experts is that a sustained decline in the interest rates is possible only if Congress continues to make progress in implementing programs of fiscal restraint and, in par-

ticular, those called for in the first concurrent resolution on the budget for fiscal year 1983.

ADMINISTRATION ENDORSES FIRST CONCURRENT RESOLUTION FOR 1983

The President's Mid-Session Review is an important statement because, under the law, it updates the April revisions of the President's February request. As I understand the document that was revised Friday past, it takes the President's policies as contained in his February 8, 1982, budget, adjusts them for updated economics and new information about spending programs and then corrects any technical data that are now out of date. This technical and economic information is important but, I must say in all candor, that the mid-Session review is less relevant to the fiscal debate in this Congress this year because, as I understand, the administration has endorsed the policies contained in the first concurrent budget resolution for 1983, the one that we are now attempting to implement.

I will ask you about that, Mr. Stockman, when we have questions.

I have every reason to believe that the administration intends to use the first resolution on the budget as the benchmark against which to make adjustments about congressional spending action.

I will also ask you, Mr. Stockman, about this very point when we moved to questions.

In addition, there are several clarifications that I would like you to address. But all in all, I believe we should focus less on the technical details in the Mid-Session Review and more on the state of the economy and the administration's view of fiscal policy needed in the future.

DEFENSE SPENDING REDUCED

In your statement, I hope that you will also pay special attention to the issue of defense; for this issue has created substantial confusion. I note that the Mid-Session Review contains moneys for defense, both budget authority and outlays, that are virtually identical to those in the President's April budget update.

However, in the Congress' resolution, the one that we have voted in that I have been alluding to, Congress reduced the President's request for outlays by $7.3 billion in fiscal year 1983, $9.9 billion in fiscal year 1984, $13.3 billion in fiscal year 1985—let me review that again—$7.3, $9.9, and $13.3 billion for the 3 years, 1983, 1984, and 1985. Those were the numbers in the resolution.

We similarly reduced budget authority for defense in each of those 3 years. It is important for us to be clear on the administration's position on spending targets for defense.

ADMINISTRATION'S POSITION ON SPENDING TARGETS IMPORTANT

To put it in broader terms, it is important for us to be clear about the administration's position on all our spending targets. This is an especially delicate time for Congress. The House and Senate conferees are now considering the Tax Equity and Fiscal Responsibility Act. That act is mandated by the reconciliation instructions and tomorrow we consider here in the Senate the Om-

nibus Reconciliation Act of 1982. Both bills are responsive to this first resolution.

The administration's support for these bills is a major determinant of their success. In addition, the levels achieved in discretionary nondefense appropriations by way of 1983 are important to the overall balance of spending restraint in the first resolution. For this reason, I hope you will be clear this morning about the benchmarks that the administration intends to use in assessing the Presidential approval of the fiscal 1983 appropriations bills this fall.

We have to fulfill the first resolution as promised to hold spending down and it is our hope that you can indicate today that in all respects the administration supports those targets and numbers.

Now, is Senator Hollings here?

Do any of the committee members want to open, or shall we go right to Mr. Stockman.

All right, Mr. Stockman, and then we shall proceed back to questions, 5 minutes each.

But before you start, I have a statement Senator Sasser has asked to be inserted into the record.

STATEMENT OF SENATOR SASSER

Mr. Stockman, with each passing day, more and more Americans are losing their confidence in the administration's economic recovery efforts.

A recent Harris survey indicates that 48 percent of the American public believe that we are in a depression, and yesterday's Harris poll shows that, by a 3-1 margin, the American people think that the administration's policies will not lead us out of the recession or reduce the deficit.

Yet the administration's response to these growing fears has been strict adherence to a set of economic propositions which have produced the largest budget deficits in the history of this Nation.

Indeed, the Congressional Budget Office has estimated that the Reagan administration will add about $427 billion to the national debt in their first four-year term.

In February of this year, the President submitted a budget which was summarily rejected by both Democrats and Republicans alike. It was premised upon economic assumption which were totally unrealistic and which defied credibility.

Most reputable economists who have reviewed the mid-session report which you have presented us with, Mr. Stockman, find this report hardly credible. One senior While House official official was quoted last week as suggesting that the administration's economic policy was entering the "twilight zone".

The former Chairman of the Council of Economic Advisers, Mr. Weidenbaum, has called the deficit projections too optimistic. Commerce Secretary Baldridge has disavowed the forecast and today has suggested that the deficit will be $20 to $30 billion more than you have projected.

Indeed, your economic projections seem to be creating a crisis of confidence in the upper ranks of the economic decision-makes in this administration. Over the past eight months now fewer than seven senior economic advisers have left the administration, including two-thirds of the Council of Economic Advisers.

Last week, Dr. Alice Rivlin of the Congressional Budget Office testified that we could expect deficits in the range of $140 to $160 billion in each of the next three years. This contrasts sharply with the estimates you present today. And this is very disturbing to me since CBO has generally been far more accurate than OMB in their deficit projections.

The prospects for a strong economic recovery are bleak.

Yet, in a very callous manner, this administration has consistently underestimated outlays, overestimated revenues and misstated the budget dificit. They have not told the truth about our budgetary situation to the American people.

In short, Mr. Stockman, it is most discouraging that with all the resources that are available to you, you have been unable to produce a credible assessment of the budgetary challenges that lie ahead of us.

Chairman DOMENICI. Mr. Stockman, you may proceed.

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STATEMENT OF DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. I am pleased to appear before the committee.

I have a lengthy statement that I would like to submit for the record and then use a few minutes to present highlights to the committee and reserve most of my time to respond to your questions.

So with your permission, I would like to submit my testimony for the record and then make a few observations.

Chairman DOMENICI. It will be made a part of the record.[1]

COMPROMISE BUDGET AGREED TO

Mr. STOCKMAN. Mr. Chairman, normally, the Mid-Session Review is a statistical and technical update of the tax and budget policies and spending priorities contained in the President's February budget. But this year, as we sat down in late June to put the Mid-Session Review together, we were confronted with unique circumstances. After laborious, difficult, and prolonged discussions and negotiations with the Congress, extending in one form or another over a 3- or 4-month period, a compromise budget was agreed to in late June. That budget compromise was embodied in the First Budget Resolution and it differed substantially from the February budget presented to the Congress by the President. It differed both on policy, where tax, spending, and budget priorities were altered significantly during the process of negotiations, and also on economic assumptions. We agreed to use a modified CBO forecast, supported by the bipartisan leadership of the Budget Committees, for the purpose of estimating the budget resolution and implementing the savings measures contained in it. This congressionally preferred forecast differed substantially from our own February forecast and generally assumed lower rates of real economic growth, a somewhat higher rate of inflation, and a lower path of interest rates during the 1982-85 period.

Now, no sooner was the ink dry on this historic measure, and I believe the First Budget Resolution is a historic measure because it sets out a plan to achieve $380 billion in deficit reductions over a 3-year period, than it was time to crank up the executive branch machinery, to produce the mid-year reestimates that are the occasion for this morning's hearing.

It was clear to us after the budget resolution had passed in late June, that the usual update of the February forecast and the administration's February budget would not be useful to us or useful to the Congress or useful to the public. It was clear that the set of numbers contained in the February document had been discarded and that the live document before the Congress was the First Budget Resolution.

FIRST BUDGET RESOLUTION UPDATED

So we made the decision to update the First Budget Resolution rather than the President's budget, in terms of the underlying eco-

[1] See p. 101.

nomic assumptions, technical estimates, and budget totals. Our purpose was to maintain continuity with the compromise budget target and assumptions that we had agreed to during the spring, and to underscore the crucial need to achieve the deficit reduction measures, $77 billion in fiscal year 1983 and $378 billion over 1983–1985, contained in the resolution.

I make these comments to underscore the purpose and the limitations of the Mid-Session Review. Given the nature of the budget cycle of last year, this year and probably for the foreseeable future, the Mid-Session Review cannot be a top-to-bottom revision of budget policy and economic outlook, but must be a limited update of the actual budget in process of implementation at midsummer. To interject a wholly new economic and budget policy framework at this point in the cycle would be highly disruptive to the legislative process. It would mean that we would never have a completed, implemented budget, but only an ever-changing series of proposed paper budgets that would do nothing to alter the tax and spending mechanism that produce real-world budget outcomes and real-world economic impacts.

What I am suggesting, Mr. Chairman, is that what counts at this stage is not that our budget estimates—and I underscore that—not that our budget estimates be 100 percent correct in some academic sense—but that the policy changes jointly committed to be 100 percent executed into law through the tax, reconciliation, appropriation, and other legislative processes available.

ECONOMIC ASSUMPTIONS

The mid-session estimates before you today are an update of a compromise budget that is only 45 days old as we meet here this morning. The highlight of this update can be noted rather quickly. We believe that nominal GNP will be at least $215 billion lower for 1982–85 than assumed by the resolution and by CBO last spring. This difference will reduce receipts and raise the deficit by an average of about $20 billion a year for 1983 through 1985 from what we assumed just a few months ago. This difference is almost entirely due to lower projected 1982 inflation than assumed in the resolution; 5.1 percent on the GNP deflator for the fourth quarter of 1982 over 1981, versus about 7 percent assumed in the resolution.

For the other economic variables, especially interest rates and unemployment, we stayed with the assumptions chosen by Congress a few months ago. We did that because in the last 30 days, short-term interest rates have declined by more than 300 basis points, thereby reducing the perspective deficit. At the same time, the outlook for near-term employment and output has deteriorated somewhat, thereby potentially increasing the deficit. It is doubtful whether the first resolution forecast can be systematically improved at this delicate turning zone juncture in the economy. The prospects are too uncertain to make a major systematic adjustment.

For that reason, we have maintained the out-year assumptions for prices and real GNP change specified in the resolution and have made minor adjustments to the 1982 calendar economics.

It seems possible at this point that the output growth assumptions for the next several quarters may be too optimistic in the resolution. At the same time, the inflation assumptions are clearly too pessimistic and it is not clear at this point by how much either of those variables need to be adjusted or what the net impact on the budget would be since they would tend to work in opposite directions.

In any case, the task of achieving $100 billion in revenue raising measures, $30 billion in entitlement reform over the next 3 years, and $13 billion in national defense and pay savings in 1983, is far more critical than any fine tuning of these assumptions that we could do at the present moment.

I would note that the economic impacts on the budget for the out years are automatic and unavoidable and can be updated later as the course of the economy and as the economic evidence becomes clearer.

By contrast, the policy savings assumed in this fiscal year 1983 first budget resolution are not automatic and if not achieved in the next several weeks or months will constitute a permanent setback to budget control, to deficit reduction, to lower interest rates, and to the economic recovery.

TECHNICAL OUTLAY REDUCTIONS

On a technical side, Mr. Chairman, the midsession update reduces outlay estimates and I underline "reduces outlay estimates" by about $8 billion per year over fiscal year 1983–85. This is largely attributable to three factors. The first factor is a $3 billion per year lower estimate for unemployment insurance-related outlays. This does not stem from a difference over the unemployment rate but from technical estimating differences over the lag between what we commonly think of as the unemployment rate, the BLS rate and the actual insured rate State by State which determines the level of unemployment outlays. There has been a break in the historic relationship between these two variables, and thus far this year, unemployment insurance outlays have lagged substantially behind what either we or CBO predicted earlier this year.

Another source of this $8 billion in technical differences, is the calculation of net interest once the T-bill assumptions are specified. We forecast $10 billion less in debt service outlays over the next 3 years, because of differences with CBO over the composition of the debt portfolio of the Treasury.

And, finally, over the 3 years there is about $6 billion in difference for a whole series of entitlement programs, including medicare, medicaid, and social security, where we forecast spending at a lower rate.

Overall, these technical outlay reductions partially offset the lower receipts due to a lower level of nominal GNP and they result in a deficit $11 billion higher than the resolution deficit for 1983, and slightly smaller upward adjustments in the resolution deficits for 1984 and 1985.

BUDGET OUTLOOK

Mr. Chairman, let me say a few words now about the preliminary estimates that you were given for the budget outlook and deficit by CBO last week for the first budget resolution policy if it were entirely adopted.

My basic characterization of those numbers, which I believe averaged about $150 billion a year in deficits, is that there is less there than meets the eye. While the deficit differences are huge, $31 billion higher, in 1983 and $166 billion higher over the 3-year period, I stress very strongly that most of this $166 billion difference in the deficit projection is due to old arguments with CBO over technical estimates of receipts and outlays and not over new arguments about the economic forecasts.

For 1983, CBO is projecting a deficit of $146 billion, assuming the midpoint of the range CBO presented last week versus the deficit of $115 billion we are presenting today. Of that $31 billion difference, only $8 billion is due to differences in economic assumptions. We tried to lay out the source of these differences on page 11 of my testimony.[1]

I would call the attention of the committee to the table on page 11 because I think if you study it you will see a somewhat different story, a somewhat different set of implications than had been suggested by the commentary and by the discussion of this forecast thus far.

You will see that in 1983, only $8 billion of the $31 billion difference is due to differences in economic assumptions. In other words, in the context of a $3 trillion economy, amd a $760 billion budget, if you take their economic assumptions, the deficit would be $123 billion. If you take the updated resolution economic assumptions, the deficit would be $115 billion. That is an insignificant difference, well within the range of estimating error.

Moreover, if you take the entire 3 years, you will see that of the $166 billion difference in forecast deficits, only $67 billion, or 40 percent, is due to economic assumptions. The other 60 percent is due to technical arguments that I will address in a moment.

Now, again, that $67 billion difference over 3 years may appear to be a large number and it is worrisome. But during that same 3-year period the budget resolution contemplates Government spending of $2.45 trillion. So what we are talking about here is a 3 percent difference in terms of the economic forecast that drives the deficit projection. The remaining difference is entirely due to technical matters. Let me compare the economic forecast that CBO presented last week with the forecast we are proposing you use as an update to your own resolution assumptions. The differences between the two are very small.

PROJECTED ECONOMIC DIFFERENCES ARE SMALL

On the matter of real GNP, we are projecting a negative 0.7 percent real GNP in 1982 and CBO projects negative 1.0 percent. That is a three-tenths of a 1-percentage point difference, and it will not have a large impact. If you go to the other end of the forecast

[1] See p. 111.

period, we are projecting 3.7 percent real growth for 1985. They are projecting 3.6 percent; again, a statistically insignificant difference. Even if you look at 1984 in terms of real growth, the basic outlook for expansion in the economy, they are projecting 3.7 percent while we are projecting 4.1 percent. This is only four-tenths of a percentage point difference, certainly a difference having almost no impact on the budget relative to its size.

The only significant difference in the forecast is real growth. The main difference between the CBO forecast of last week and the updated Mid-Session Review that we are presenting here today is for 1983. In 1983 we forecast a 4.4 percent rate of real growth compared to the CBO forecast of 3.5 percent, again, less than a 1 percentage point difference.

I would point out, Mr. Chairman, that all of these differences combined would result in less than a few billion dollars impact on the budget over the 3-year period.

If you take a comparison of the inflation differences, we are almost identical; a one-tenth of 1 percentage point difference in the GNP deflator for calendar 1982 through 1985. So again, on that dimension of the economics that does drive part of the budget in terms of indexed programs, there is almost no difference.

On unemployment, the difference averages less than five-tenths of 1 percentage point a year, and given the size of the budget and the sensitivity to unemployment, that is a $4.4 billion impact; again, not a source of the major difference in these projections.

I would point out to the committee this morning that the only significant difference between the two forecasts on economic assumptions is the interest rate projection over the next 3 years. We used the congressional resolution assumptions, starting with a 12 percent T-bill rate in 1982, declining about 2 percent a year through 1985. By contrast, CBO has assumed that the T-bill rate will stay as high as 9 percent by 1985. Well, I note the fact that the T-bill rate yesterday was 9.6 percent and I think their guess is as good as yours or ours as to whether more than 500 bases points of progress will be made over the next 3 years. We believe that the interest path will improve if we reduce the deficit as planned. In all, Mr. Chairman, the economic differences are very small.

Chairman DOMENICI. Would you let me interrupt, please? I have been told about 10 or 15 minutes ago that the majority leader has five back-to-back votes planned at 11 o'clock. Even if we waited into that first one, we would have to leave at 10 after 11. I would like you to complete as quickly as possible so members will have an opportunity to inquire.

What do you estimate?

MAJOR DIFFERENCES DUE TO TECHNICAL ESTIMATING

Mr. STOCKMAN. It will take me about 5 minutes.

The second point I wanted to make is that most of the difference between these deficit projections is due to technical estimating differences that account for $96 billion out of the $166 billion 3-year difference. But of that $96 billion difference over the 3 years, $66 billion is due to outlay and receipt reestimates that this committee, the House Budget Committee, and the Congress rejected explicitly

in the first budget resolution. Nearly $38 billion of that difference is due to a revenue reestimate for the same GNP and the same tax policy you rejected before. We believe the Treasury estimates are better. We do not believe this is a realistic element of the budget projection picture.

Similarly, $28 billion of the $96 billion difference is due to outlay reestimates. Again, this committee rejected those reestimates earlier and we believe your judgment was right.

So what I am saying, Mr. Chairman, is that there is a very uncertain picture for the economy over the next several quarters, but in terms of our projections of the budget deficit, that uncertainty does not enter in a large way in the vastly different numbers that CBO has produced, versus those in the document before you today. Those are technicial differences.

UNDERLYING RATE OF INFLATION REDUCED

Now, Mr. Chairman, the other point that I would like to make this morning, and since it is contained in my testimony I will simply call your attention to it, is that even though we are in a very difficult transition period in the economy, and even though some of the signs are pointing down and some up and some are confusing, I think it is important that we not lose sight of the fact that there has been dramatic progress in reducing the underlying inflationary disorder that afflicted the economy in late 1978, 1979, and 1980. We have reduced the underlying rate of inflation by half, from double digits to five or six. This reduction in the inflationary bias in the economy is a crucial precedent to long-term growth and sustainable real expansion of the economy. This progress has been made at a great cost and should not be abandoned now as the economy completes the process of repairing and healing itself.

What that suggests to me, Mr. Chairman, is that rather than looking for new policy directions, rather than looking for quick fixes on either the fiscal side or the monetary side, we have to persevere with a basic economic recovery program that we have put in place; persevere in the difficult task of implementing this budget resolution; persevere in our long-term objective of bringing Government spending commitments in line with revenues and taxation. That policy is consistent with economic growth and a healthy and prosperous economy in the future.

RECONCILED ENTITLEMENT SAVINGS ACHIEVED

I would note that the Senate has made enormous progress in the last 30 days in implementing the difficult measures contained in the resolution. By our calculations, the Senate committees in the aggregate have achieved over 100 percent of the reconciled entitlement savings. The Appropriations Committee has produced a 302(b) allocation that is consistent with the savings in the resolution and on an overall basis, the Senate despite all of the political pressures to the contrary, is moving to implement almost 100 percent of the deficit reduction measures contained in the resolution for 1983 and for the out-years. This is commendable progress under very difficult circumstances and I am here this morning, Mr. Chairman, to indicate that we intend to do whatever we can to help as you com-

plete the very critical and important job of bringing economic recovery to this country.

Thank you very much.

Chairman DOMENICI. Thank you very much, Mr. Stockman.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

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STATEMENT OF THE HONORABLE DAVID A. STOCKMAN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SENATE BUDGET COMMITTEE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am here today to discuss the Mid-Session Review of the 1983 Budget and to express my support for the First Budget Resolution and the actions the Senate has taken to implement it.

Last year's Congressional Budget Resolution and the Omnibus Budget Reconciliation Act of 1981 made a significant start on curbing the unsustainable rate of growth in Federal spending for nondefense programs. This year's resolution, if fully effected, will make another very substantial contribution to this critical effort. Implementation of the Resolution will lower the rate of growth of Federal spending from more than 17% in 1980 to about 7 1/2% in 1985. It will reduce the Federal spending share of GNP by an average of a full percentage point each year -- from 24% in 1982 to 21% in 1985.

THE BUDGET OUTLOOK, 1981-1987
(in billions of dollars)

	Actual	Estimate			
	1981	1982	1983	1984	1985
Receipts	599.3	622.1	646.5	719.9	801.1
Outlays	657.2	731.0	761.5	812.5	874.7
Surplus or deficit (-)..	-57.9	-108.9	-115.0	-92.6	-73.6
Addendum: Percent of GNP					
Receipts ...	21.0	20.5	19.3	19.4	19.6
Outlays ...	23.0	24.1	22.8	21.9	21.4

The above figures are based on the Mid-Session Review of the 1983 Budget, which was released last Friday. In the past, this Review has served as an update to the President's budget estimates. While this year's Review serves that purpose in a technical sense, in practice it is really an update of the First Budget Resolution.

Although different in many respects from the Administration's budget presented last February, the First Budget Resolution is consistent with the general thrust of Administration economic policy, particularly the commitment to sustained deficit reductions as a means of strengthening prospects for steady interest rate reductions and sustained economic recovery. The Administration therefore considers successful legislative implementation of the Resolution to be its most immediate fiscal priority.

Economic Assumptions

To further prospects for this implementation, the Review is designed to serve the limited purpose of updating the Resolution only for recent economic and budget data. It does not reflect a reassessment of the economic forecast or the budget policies that underlie the Budget Resolution. Such a reassessment would be premature at this time.

The economic assumptions in the Mid-Session Review are essentially those used by the Congress in the preparation of the Resolution, modified to reflect recent actual data for the first half of 1982, plus Administration estimates of their near-term effects on the second half of the year. The primary difference for 1982 in the Mid-Session Review is lower projected inflation. As shown in the accompanying table, from the beginning of 1983 onward, the rates of change of prices and output, and unemployment and interest rates are those assumed in the Resolution.

Use of the Resolution economic projections in the Mid-Session Review does not constitute Administration endorsement of these assumptions as forecasts or as economic policy objectives. They are used instead to conform as much as possible with estimates in the Resolution and to facilitate enactment of the critical deficit reduction measures that it embodies.

COMPARISON OF ECONOMIC ASSUMPTIONS
(Calendar years)

	1982	1983	1984	1985
Nominal GNP ($ billions):				
Mid-Session Review	3090	3436	3812	4190
Resolution	3116	3493	3875	4259
Difference	-26	-57	-63	-69
Growth Rates (percent changes, fourth quarter over fourth quarter):				
Nominal GNP:				
Mid-Session Review	6.9	11.7	10.6	9.6
Resolution	8.5	11.7	10.6	9.6
Real GNP:				
Mid-Session Review	1.7	4.4	4.0	3.5
Resolution	1.6	4.4	4.0	3.5
GNP Deflator:				
Mid-Session Review	5.1	7.0	6.3	5.9
Resolution	6.9	7.0	6.3	5.9
Unemployment Rate:				
Mid-Session Review	9.2	8.4	7.6	7.2
Resolution	9.1	8.4	7.6	7.2
91-Day Bill Rate:				
Mid-Session Review	12.0	10.7	8.8	6.9
Resolution	12.0	10.7	8.8	6.9

Economic Appraisal

As indicated, the principal objective of the Mid-Session economic assumptions is to conform with estimates in the Budget Resolution, while taking account of economic developments thus far in calendar 1982. However, in an effort to continuously monitor economic conditions, our current appraisal suggests that the recent chorus of growing economic pessimism is unwarranted. Inflation has declined, and this move toward lower inflation is laying the groundwork for a steady and sustainable economic recovery. Business conditions have clearly bottomed, and there are numerous signs of improvement that suggest the economy has entered a turning zone, moving from recession to recovery.

The most important factor in the outlook for recovery is the substantial progress that has been made in controlling the rampant inflation inherited by this Administration. No matter what the inflation measure, the progress is impressive. Averaging changes in four different measures -- the consumer price index, the producer price index, hourly earnings, and the GNP deflator -- the inflation rate has been cut nearly in half during the past 18 months. In the 12 months before this Administration took office, the average inflation rate was almost 11 percent; in the past 12 months, it has been brought down to 6 percent.

INFLATION RATES
(percent change from one year earlier)

Year Ending	CPI	PPI	Wages	GNP Deflator	Average Inflation Rate
Dec. 1980	12.4	11.8	9.3	10.2	10.9
Jun. 1981	9.6	10.5	9.0	9.4	9.6
Dec. 1981	8.9	7.1	8.2	8.9	8.3
Jun. 1982	7.1	3.5	6.9	6.8	6.1

The decline in inflation during this recession, roughly one-third, has been sharper than in any other in the past 3 decades. During past recessions the decline in average CPI inflation has been much smaller, roughly only one-twentieth. Moreover, there is considerable evidence that inflationary expectations have receded, and this is nowhere more evident than in commodity and tangible asset markets.

The disruptive speculative behavior that brought gold, silver, and other commodity prices to astronomical heights during 1978-80 -- and brought the dollar to new lows -- has been reversed. The level of the dollar has reached a 10-year high, and unproductive commodity speculation has been curbed, as reflected in the following table:

PRICES OF COMMODITIES AND TANGIBLE ASSETS

	Peak Since Late 1980		June 1982	Percent Change
Commodity Price Index 1/ ..	298	(Nov 80)	240	-19.5
Raw Materials Index 1/....	305	(Nov 80)	233	-23.6
Gold ($/oz)	664	(Oct 80)	312	-53.0
Silver ($/oz)	20	(Oct 80)	5	-75.0
Copper (¢/lb)	99	(Oct 80)	68	-31.3
Old Masters Paintings 2/..	255	(Sep 80)	209	-18.0
Continental Ceramics 2/...	336	(Sep 80)	266	-20.8
Crude Petroleum Index	843	(Mar 81)	719	-14.7

1/ Source: Commodity Research Bureau
2/ Source: Sotheby's Index

The combination of lower inflation and incentive-oriented tax-rate reduction points strongly toward an across-the-board strengthening in purchasing power and a sustained pickup in economic activity. The evidence in recent months indicates that the recession has bottomed and the economy is displaying the early signs of improvement that are characteristic of the turning zone of recovery.

- Real disposable income increased at an annual rate of 3.1% during the second quarter.

- Real personal consumption expenditures rose by 3.0% in the second quarter, following a 2.5% rise in the first quarter.

- Real hourly earnings have been positive since December, the first such sustained rise in real wages in 3 years.

- As a sign of consumer improvement, retail sales in the second quarter increased at a 13.4% annualized rate, or 10.5% adjusted for inflation.

- New housing permits have increased by 28.5% during the past 8 months, and real residential construction investment grew by an annualized 3.1% in the second quarter.

- The ratio of nonfarm inventories to final sales of goods and structures peaked in the fourth quarter of 1981 at 4.64, and declined to 4.57 in the second quarter of 1982. With inventories pared back, and final demand on the rise, production and employment will be picking up during the months ahead.

As a last note on the current economic scene, no discussion is complete without touching on the difficult interest rate situation. In response to higher deficits, financial market participants and people throughout the economy remain concerned over the future behavior of interest rates. If left unresolved, this anxiety is likely to

diminish prospects for a lasting economic recovery. Of course, it is precisely for this reason that the Administration is placing so much emphasis on the need for successful legislative implementation of the entitlement, other spending and tax measures provided in the First Budget Resolution passed by Congress.

However, on the brighter side, it is worth noting that the overall inflation reduction and the considerable progress achieved thus far on the Budget Resolution have generated a salutory effect on interest rates. Indeed, financial market conditions have been gradually unwinding throughout most of 1982. The 3-month Treasury bill rate has been averaging below 11% in recent weeks, compared to a 17% peak in June of last year. In recent days, the bill rate has been trading around 9 1/2%. The prime rate has dropped to 15% from a peak of 21% in December 1980, and further prime rate reductions are expected during the weeks ahead. These interest rate reductions are of particular importance in the current economic environment, and if continued they would become a key factor in the recovery picture during the second half of 1982.

98-044 O - 82 -- 8

Budget Outlook

The budget implications of the differences in economic assumptions between the Mid-Session Review and the Resolution are substantial, principally because of the lower inflation in calendar year 1982. The lower inflation results in reductions in GNP relative to the Resolution of $55 to $70 billion per year in the 1983-85 period, and therefore results in reductions in receipts of $15 to $20 billion per year. Although the increases to the deficit resulting from the reductions in receipts are partially offset by technical reestimates and other differences in the Mid-Session Review, the deficits are nevertheless significantly higher than in the Resolution.

MID-SESSION AND RESOLUTION DEFICITS
(in billions of dollars)

	1983	1984	1985
Resolution deficit	104	84	60
Deficit effect of:			
Reduced receipts (largely due to revised incomes)	19	18	20
Reduced outlays (largely due to technical reestimates)	-8	-9	-7
Mid-Session deficit	115	93	74

The Mid-Session Review deficits, while higher than the Resolution, are much lower than the preliminary deficit projections presented to this Committee last week. Based on their technical estimates of last Spring, and their preliminary assessment of the economic outlook, CBO projects deficits of about $150 billion per year in the 1983-85 period. About 40% of the increase in the projected deficits relative to the Mid-Session Review is due to economic assumptions. Most of the remaining 60% is due to technical estimating differences.

MID-SESSION AND PRELIMINARY CBO DEFICITS
(in billions of dollars)

	1983	1984	1985	1983-85 Total
Mid-Session deficit	115	93	74	281
Revised economic assumptions	8	28	31	67
Technical reestimates rejected in Resolution:				
Receipts	5	11	22	38
Outlays	8	9	11	28
Subtotal	12	21	33	66
Additional technical reestimates in the Mid-Session Review:				
Unemployment compensation	3	3	3	9
Net interest	2	3	5	10
Social security, Medicare and Medicaid	1	3	2	6
Other	2	2	1	5
Subtotal	8	11	11	30
Policy differences	2	-1	2	3
Total differences	31	59	76	166
Revised CBO deficit 1/	146	152	150	448

1/ Assumes midpoint of CBO range
Note: Detail may not add to total due to rounding

Memorandum: Share of estimating differences between Mid-Session and CBO:

Economic assumptions	26%	47%	41%	40%
Technical reestimates:				
Rejected in Resolution	40%	35%	43%	40%
Additional	27%	19%	14%	18%
Total	67%	54%	57%	58%
Policy	7%	-1%	2%	2%
Total	100%	100%	100%	100%

Budget Impact of Disinflation

The economywide shift to lower inflation, the recession that has accompanied it, and the temporary occurrence of extraordinarily high real interest rates has had dramatic effects on the budget outlook. Lower nominal GNP growth, due both to lower inflation and to the recession, is the major contributor to the increased deficits. As shown in table below, the shortfall in receipts that results from the shortfall in nominal GNP occurs not only with respect to the Administration's March 1981 forecast but also with respect to the CBO forecast made at the same time. Receipts in each year are reduced by $70 to $100 billion due to the GNP shortfall, and this receipts shortfall has resulted in a substantial increase in debt service costs.

BUDGET EFFECT OF REVISED ECONOMIC ASSUMPTIONS
(in billions of dollars)

	1983	1984	1985
Change in GNP (calendar years):			
Administration March 1981 to July Mid-Session	-264	-286	-310
CBO March 1981 to July Mid-Session	-231	-273	-373
Effect of Revised GNP on Receipts (fiscal years):			
Administration March 1981 to July Mid-Session	-80	-74	-79
CBO March 1981 to July Mid-Session	-70	-70	-95
Effect of Reduced Receipts on Debt Service Costs (fiscal years):			
Administration March 1981 to July Mid-Session	-6	-15	-23
CBO March 1981 to July Mid-Session	-5	-13	-23

Source: OMB estimates

The effect of disinflation on the spread between inflation and market interest rates has also had dramatic budget effects. The "real" interest rate for 91-day Treasury bills was slightly negative, on average, during the 1970's. In contrast this rate was 5% in calendar year 1981 and is projected to be 5 1/2% in 1982. Neither public nor private forecasts projected these large rates or accurately foresaw their extraordinary budget implications. If real interest rates in the 1980's were the same as in the 1970's, Mid-Session Review estimates of debt services costs would be substantially reduced from current projections, as shown below.

EFFECT OF CHANGE IN REAL INTEREST RATES ON DEBT SERVICE
(in billions of dollars)

	1982	1983	1984	1985
Rate effect	-34	-37	-32	-25
Debt service on lower rates	-3	-6	-8	-11
Total	-37	-43	-40	-36

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* Figures calculated from difference between 1970's average real rate (-0.2%) and real rate assumed in Mid-Session Review.

Reconciliation Progress

The fiscal challenge we face will require determined action over the next several years to achieve our fiscal policy goals. A necessary preconditon for success is to take the essential first step of enacting the deficit reduction measures contained in the First Resolution. And the Administration believes that the Senate is moving responsibly forward in this direction.

In the matter of Reconciliation, Senate Committees have produced legislation that, in our view, signals responsible Senate action. The overall instructions savings are $11.18 billion for FY 1983-85 for bills other than the Finance Committee package already approved by the Senate. Based upon CBO scoring, we believe the Committees' legislation, if adopted without amendment, would actually exceed the target slightly, producing savings close to $12 billion.

SENATE RECONCILIATION

	1983	1984	1985	1983 to 1985
Resolution entitlement targets ...	-7.7	-11.8	-14.2	-33.7
Reconciliation instruction targets	-6.5	-9.3	-11.3	-27.1
Committee-reported savings:				
Finance Committee Bill 1/.....	-4.1	-5.8	-6.8	-16.7
Other Committees	-2.5	-4.0	-5.7	-12.2
Total Savings	-6.6	-9.8	-12.5	-28.8
Senate Savings as a percentage of:				
Resolution	86%	83%	89%	86%
Reconciliation instructions ..	102%	105%	111%	107%

1/ Passed Senate

The Conference that meets this week, Mr. Chairman, has before it a Finance Committee package that also successfully reflects the Senate's commitment to reach the deficit reduction targets. With persistence, the Administration believes that these measures can be enacted soon.

Finally, the Senate Appropriations Committee has, in our view, also acted to establish 302(b) targets that are consistent with the spirit of the Resolution. While the functional allocation of discretionary authority implicit in those allocations reflects differing priorities from either the Resolution assumptions or the President's budget requests, we believe that the overall task that the Senate set for the Appropriations Committtee can be successfully completed. If the Senate 302(b) allocations are firmly adhered to and all Resolution assumptions regarding current level, entitlement and other additional spending reductions are observed, we believe the Resolution savings for discretionary programs will be achieved.

In all, Mr. Chairman, I would like to commend you and your colleagues for your efforts to move forward in such a determined fashion. We look forward to working with you and the Members of this Committee on this difficult -- but essential task.

Chairman DOMENICI. I will be very brief.

It is correct, then, as I understand your testimony, that the administration intends to use the first concurrent budget resolution as the benchmark against which to judge spending bills passed by Congress the remainder of this year.

Is that correct?

Mr. STOCKMAN. That is correct, Mr. Chairman.

ADMINISTRATION'S INTENT ON DEFENSE OUTLAYS

Chairman DOMENICI. In the case of defense, what is the Administration's intent for 1984 and 1985, and what about further domestic cuts those years?

Mr. STOCKMAN. Mr. Chairman, our intent is to fully comply with the decision of Congress to reduce defense function outlays by $8.6 billion in 1983. Some of that reduction that will have to be achieved through the pay cap, some of it through the COLA cap, and the rest of it by the Appropriations Committee by reducing the requested level of budget authority for the military construction bill and for defense appropriations. We have not submitted a formal budget amendment but we intend to work with the various committees involved to make sure those targets are met.

For the out-years the President is firmly committed to the net outlay reductions contained in the budget resolution. As I recall, the resolution is about $4 billion below what we proposed for 1984 outlays; $812 billion for 1984 in the resolution versus $816 billion proposed in the April update of the President's February budget.

The President, believes however, that it is essential that he retain at least the prerogative to review the situation this fall in preparation for his own budget submission in January. He will achieve the outlay savings contained in the resolution and then more if they are needed to reduce the deficit in keeping with the facts and circumstances presented at the time and with the national interest in balancing deficit reductions and national security improvement. So although we feel bound by the overall outlay targets for the out-years, we do note that for discretionary spending both for defense and for nondefense, the Congress will review those issues next year and the President believes that he must have the opportunity to make his own final decision before he submits next year's budget.

REDUCTIONS IN NONDEFENSE SPENDING NECESSARY

Chairman DOMENICI. What you are saying then, Mr. Stockman is that the President intends to meet those net reductions in submissions in the budget you intend to bring us. If he does not intend to reduce defense as much as targeted, then you are telling us it is your intention to reduce other programs by that amount.

Mr. STOCKMAN. Mr. Chairman, if the decision were made to retain the full amount in the February budget, then it would be necessary to reduce nondefense programs.

As a practical matter, it will be necessary in the 1984 budget for both the administration and for the Congress to substantially reduce nondefense spending beyond what we have already done in

this resolution, in order to close the budget deficit gap that we will still face when we approach the question next year.

Chairman DOMENICI. Thank you.

Senator Metzenbaum?

CONGRESS BLAMED FOR RECESSION

Senator METZENBAUM. Mr. Stockman, the other evening the President spoke at his press conference and he led the American people to believe that the reason we have a recession in this country is because Congress did not give him that which he requested. Now, Congress gave him the reconciliation instruction bill which cut spending by $120 billion, the first budget resolution which included big defense buildup of $150 billion; we passed the actual reconciliation bill and the House passed the Gramm-Latta bill; the Congress passed the tax bill of 1981 which cuts taxes $750 billion; the Congress passed the new budget resolution for fiscal 1983-84 which took 6 months to work out an agreement on; and the Senate just passed a new tax bill, increasing taxes $100 billion.

On that basis, how can the President tell the American people that the Congress is to blame for this recession when they gave him everything and, in some instances, more than he asked for?

ALL REQUESTED SPENDING REDUCTIONS NOT ACHIEVED

Mr. STOCKMAN. Senator, as I recall, that remark was more in the context of why is it necessary to have a $100 billion revenue bill when our basic thrust has been toward cutting taxes. I think the President's answer was that because we have not obtained all the spending reductions we requested, and because we are faced with a very large and economically detrimental deficit, driven by the state of the economy, it has become necessary to enhance revenues. I am not sure of the entire context of the discussion, but I believe that was the context in which that statement was made.

Senator METZENBAUM. Let me read you what he said. I could turn around and say how much less that deficit would be if the Democratic leadership that House pounced on this nice little thrust that you have just repeated if they had given us all that we asked for last year and these reductions in government spending. But we have never gotten yet what we asked for.

Mr. STOCKMAN. That is what I said, Senator. The context of that statement was that we simply had not achieved all the spending reductions that we requested.

I would be happy to submit for the committee——

Senator METZENBAUM. Tell us now what you did not get? You got everything you asked for. We passed every measure you wanted. You worked out a deal between the Democrats and the Republicans in the House.

The Senate passed what you asked for and the President has the audacity to tell the American people that it is all Congress fault and that is the reason we have this recession.

Now, how do you explain that?

Mr. STOCKMAN. Well, I would simply request the opportunity to submit for the record figures that will show that our proposed spending reductions in both the 1982 and the 1983 budget were

tens of billions of dollars above what the Congress implemented last year in reconciliation and this year in terms of its agreement on the budget resolution. Those are factual matters and I believe that is what the President was pointing to.

Senator METZENBAUM. Let me point this out to you. In fiscal year 1983 budget submission, the President requested spending reductions totaling $188.2 billion over 3 years. In the first budget resolution, Congress reduced spending $283.5 billion over 5 years, $95.3 billion more than under the President's budget submission.

How can you sit there and say you did not get all you wanted? You got more than you asked for.

Mr. STOCKMAN. That number includes interest savings and debt service savings. If you split those out, I think you will find a somewhat different picture. Furthermore, I will submit for the record figures showing that the total spending reductions agreed to last year and in the resolution this year were far less than we requested.[1]

EXTENDING UNEMPLOYMENT BENEFITS

Senator METZENBAUM. Let me ask you another question.

I have legislation pending to extend unemployment benefits an additional 13 weeks. Certainly, we know that what has happened to the economy—we know the extent of unemployment in this country. We know it is over 12 percentage points in my own State. Factory production is at 70 percent, only 40 percent in autos. There is a plan in Congress to extend unemployment benefits. The Assistant Secretary of Labor for Policy and Research stated the other day that the administration strongly opposes an extension of benefits and when the question was asked of him at the Finance Committee, what is the administration's proposal, the answer was, "None, sir."

Today's Wall Street Journal indicates that the administration is now talking about supporting an increase in unemployment benefits at 13 weeks.

What is the administration's position with respect to extending unemployment benefits an additional 13 weeks?

Mr. STOCKMAN. Senator, I do not believe the Wall Street Journal would be a very good source to determine the administration's position. Our view and our position at the present time is that it would not be a wise idea to add another 13 weeks to the basic system of 39 weeks that we have in place at the present time. We do think there may be some problems in a technical sense with the way the extended benefit triggers are working and that perhaps some adjustment is needed. But we ought to focus on that problem for the 50 States—or at least the 35 States that have extended benefits in effect at the present time—before we have any discussion of a multibillion-dollar program to add an additional 13 weeks on top of the basic 39.

Chairman DOMENICI. Senator Andrews?

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[1] Not received at time of printing.

PRESIDENT NEEDS ABILITY TO CHANGE OUT-YEAR FIGURES

Senator ANDREWS. Mr. Stockman, consistently you have recommended that we cut Federal spending for appropriated accounts and for entitlements. You did that again today. At the same time, your administration has projected in its mid-session review an increase in budget authority of nearly $10 billion for defense.

Now, a moment ago you came down deeply on both sides of the fence on that one. You said that you went along with the budget projects for the out years in answer to the question of the chairman but that you felt that you had to reserve to the President the ability to jump away from that out year budget reconciliation.

How in the devil can you have it both ways without sending a totally unclear signal to the financial community of this country that we are trying to get these interest rates under control? How can the administration continue to attempt to increase defense spending at this kind of rate, recognizing what it does in these out year deficits?

Mr. STOCKMAN. Well, Senator, I would say that the budget resolution consists of two parts: those measures that are changes in law permanent that are reconciled for 3 years, taxes, and discretionary programs that are reconciled through the 302(b) process of your committee for 1 year. I fully recognize that there are many members of this committee and other committees who believe that we should not freeze some domestic programs through 1985 and will want to revisit those domestic programs in the context of the 1984 budget resolution and the 1985 budget resolution. We would note the same thing for defense.

The budget resolution is binding for 1 year. Your committee has done that on the 302(b) allocation. That will require a $12 billion reduction in our budget authority request. We are prepared to comply with that request and work with defense appropriations and the committee to achieve it in the most reasonable and least damaging way.

But for the outyears, the President must retain the ability under discretionary programs, defense and nondefense alike, as you will, to reexamine the precise level of the request that is forwarded to the Congress in light of the budget, national security, and economic circumstances of the time. There should be no mistake that even though the document shows the February defense number for 1983, that is only at the function and account level. At the aggregate level it shows the congressional level and we intend to achieve it precisely as the Congress has specified in 1983.

FIRM OUTYEAR FIGURES NEEDED

Senator ANDREWS. When you adopt that attitude, you are undoing everything this committee is trying to do. We are told by economist after economist, liberal and conservative alike that come before this committee, that it is those second and third out-year deficits that keep interest rates where they are today. You say, yes, we have to put controls on spending; yes, we have to send a strong signal to the money market; but, no, we have to retain under the administration the ability to increase by $10 or $15 billion or more

our ability to stick 10 warhead missiles down into a silo that has the capacity for three. That is a hell of a lot of sense.

There are a lot of things in this defense budget that can be cut by a revenue controlling defense appropriations subcommittee. There are many things in the outyear demands of your Administration that need to be cut, should be cut and can be cut in defense measures, but the basic need that we have in the country today is to get firm outyear figures. We cannot do that if the Administration continues to waffle.

For that reason, I intend to support the Cranston amendment to the constitutional amendment saying that the President should send up a balanced budget just as well as Congress should balance the budget. I am getting sick and tired of getting it both ways. I do not see how you can come to us and say the Congress has to do better and then leave yourself the leeway to juggle with the figures in the outyears.

How can we continue to have the impact we need to have on the economy when you want the ability to slip, slide, and duck in those outyears?

Mr. STOCKMAN. Senator, let me say two things.

One, as an influential member of the Senate Appropriations Committee, I have no doubt that your strong views on this question will be reflected in a final decision.

Senator ANDREWS. I am just trying to get along.

Mr. STOCKMAN. Those views will be reflected in the final decisions next year. In terms of the outyears, we are going to come in at the congressional target or below on total spending and it is simply a question of how those reductions are spread. You are talking about $12 billion out of an $800 billion budget between defense and nondefense. The only thing the President has said is that he is committed to the target, but reserves the right to make the final call on the precise spread or distribution of those savings next year. Because of the President's national security responsibilities under the Constitution, he has to retain that limited right, even as he commits to the overall spending reduction and deficit reduction target that you have laid out.

Senator ANDREWS. Thank you, Mr. Chairman.

DEFENSE NUMBERS CANNOT CONTINUE TO FLUCTUATE

Chairman DOMENICI. Thank you, Senator.

I want to say Senator Chiles is next. He is going to give me 30 seconds, I am sure.

I think your explanation is fine, Mr. Stockman, but, you know, the problem is that the defense establishment is going to begin their work against the higher targets and not the lower ones. That is the problem we are going to have. Granted, we are in control. The President sent the budget up. Appropriations can cut it. But I just know what is going to happen over there. Instead of the new numbers, the old numbers are going to be used. They will look at all the programs vis-a-vis those new numbers and we are going to get a finished job by the time it gets up in here. You will get a finished job; do not worry about that, even though you are the boss of the budget. But that is what will happen. We will not get much

of a chance. It will be the same thing. We already have it in; we cannot take it out. We are going to have to be very careful.

Senator Andrews is right. If we want to wrestle with this budget control, if we want to get these deficits down in a credible way, we cannot continue to fluctuate on the defense numbers. However, I understand the President needs the flexibility and he always has it. He is the President.

Having said that, I am sorry for taking your time, Senator Chiles.

TRUST BETWEEN THE PRESIDENT AND CONGRESS

Senator CHILES. Thank you, Mr. Chairman.

I think basically what the concern is here is that we are talking about a situation of trust. We are talking about trust between the Congress and the President of the United States. The President has said, as you know, the key to the deficit reduction is the reconciliation instruction and the fact that it is binding for three years.

Now, if part of this is not going to be binding, does that mean that the Congress should go back and look at the reconciliation instruction and say we should not be bound on the tax side; we should not be bound on the spending cuts that we agreed to make?

You know, the President sent a budget up here. That budget did not get a single vote in either House. So the chairman of this committee constructed a budget. That budget came to this committee and was voted out. The President said, "I agree with that". That budget had $40 billion in social security savings and some other medicare cuts and the Republicans decided that was too big; they could not swallow it. So they came up with Domenici II and the President said, "I approve that; I am for that". Then we had the Latta budget in the House and the President said, "I approve that."

Now after approving Domenici II and the Latta budget, the President is saying, "I am not bound. You are all bound. You are bound by the numbers. You are bound by the spending cuts. You are bound by the tax increases; but I am not bound by the package."

Now we are looking at vetoes. We see the veto of the Lugar housing bill. The Lugar bill was in the Latta resolution and the President approved Latta, but he then vetoed it. Then, we see a veto of the second emergency supplemental bill which contained items which you then said were too high, but which had been approved in the First Budget Resolution last year, in the Second Budget Resolution, part of the House compromise, and part of the Emergency Agreement, where when they added additional features in for education.

Now it looks like to me the President will make a deal and say he is going to approve something to get the Congress to pass it, but once the deal has been cut, then he is not bound; he can veto it. He can say, "I am not bound by the defense figure; I am not bound by any of these figures."

What I would like to know is, Is the President going to remember the compromises that were made in the Latta bill this time, which added $250 billion over for education, for veterans, for the

space program? Is the President going to be bound by those things? When the appropriations bill comes along, and they are within the budget resolution, is he going to veto it and say, "Shame on this Congress for appropriating too much money?

BINDING NATURE OF BUDGET RESOLUTION

Mr. STOCKMAN. Senator, you have asked a number of questions and I will try to answer them one by one.

First, on the binding nature of the budget resolution, it seems clear to me that the budget reconciliation is binding only for specified entitlements, and for revenue tax code law changes over 3 years, and that an appropriated program or discretionary program is binding for 1 year through the mechanism of the 302(b) allocation. The Senate committee, of which you are a member, has now completed its 302(b) allocation. It has taken the sum of all the discretionary outlays and budget authority provided in the resolution and spread them as it saw fit among all the domestic and defense programs. We believe those numbers will achieve the intent of the resolution, and we intend to use the veto only when the committees of Congress break the 302(b) allocation that they have imposed on themselves. We are not going to use the February number for any of the programs you mentioned.

Now, second, it is clear that on the discretionary programs you must review the outyears next year in the resolution, as we must, because it is a 1-year process. I would note that this year's resolution theoretically freezes the Drug Enforcement Agency, the Customs service and a variety of other agencies that you have some concern about through 1985. I doubt that you are going to be any happier with those numbers for fiscal year 1985 than the President is with the defense number for 1985. But we will have plenty of chances to argue about it next year and the year after without either side detracting in any way from the resolution.

Finally, on these matters of the Lugar housing bill and others, the budget resolution is a series of targets; about 10 that are important, the aggregates for outlays, revenues, and deficits, the major functional divisions in the current year between defense and nondefense, and the reconciliation assumptions. But we do ourselves a disservice if we try to translate that very scant, that very vague budget resolution, into a thousand-page recipe of line-item accounts, appropriated items and assumptions about every kind of activity in the budget. It is not an appropriations bill. It is not a complete budget. We must retain the right as the congressional committees must, to see how those larger targets, subaggregates and aggregates, are translated into detailed legislation and not argue about whether a resolution a year old provided for one piece of legislation because, clearly, the resolution is not a beast of that character.

Senator CHILES. Mr. Stockman, the way it sounds to me, is like you are the President's lawyer and you are saying, we are going to be bound only by the four corners of the contract. We are not going to be bound by the spirit of this agreement, only by the letter. It sounds like if the Congress wants to see that there is anything binding, we have to make sure we write it a lot tighter than we

have been writing it, where we are talking about spirit because we are now seeing that you are only going to be bound by the letter of the law and not the spirit of what we are doing.

Chairman DOMENICI. The Senator's time has expired.

I am sure Mr. Stockman would like to answer that, but you can answer it in the next question, whatever the question is.

Senator Gorton?

INTEREST RATES

Senator GORTON. Mr. Stockman, you point out in your formal statement the gratifying fact that for the last several weeks we have begun to see some downward movement in interest rates. You will certainly agree with all of us that while that is in fact gratifying, interest rates are still far too high to be consistent with strong economic recovery and strong and sustained growth.

Do you think that if we assume the accuracy of CBO's projected budget deficit over the next 3 years or, for that matter, even some figure between those and this midyear review and those of CBO, that there is any possibility, with a responsible monetary policy, of lowering the interest rate to a point at which they are highly consistent with the strong housing industry and strong growth in the economy as a whole?

Mr. STOCKMAN. Well, Senator, I am not sure what your benchmark for a rate sufficiently low to be consistent with a strong housing and general economic expansion would be. I would say this morning that while the progress has been gratifying and should improve the economic outlook for jobs and employment and production in the next several quarters, that progress is not nearly enough to support the long-term expansion of investment and production that we need. It will take renewed efforts by the administration and Congress in the 1984 budget to make further progress in closing the deficit gap. Reducing the borrowing requirement, and eliminating pressure on the financial markets must occur if rates are to fall to a level consistent with long-term growth.

ENTITLEMENT PROGRAMS MUST BE REDUCED

Senator GORTON. In short, we are going to have to lower the growth spending rate again next year?

Mr. STOCKMAN. In a major way.

Chairman DOMENICI. I did not hear that question.

Senator GORTON. We are going to have to lower the growth rate of Federal spending programs again next year, and the answer was, in a major way.

In order to do that, we are going to have to take on major entitlement programs, are we not?

Mr. STOCKMAN. Senator, I think it is fairly obvious from the anatomy of the budget that a substantial portion of outlays and most of the growth is in major entitlement programs. You are not going to solve this problem until you find solutions to that excessive growth.

Senator GORTON. As you know, Mr. Stockman, this committee has attempted to do that without cooperation from the President in large measure, beginning as long ago as March or April of 1981. By

your statements here are we assured that after the election is safely past, that the administration will come up with measures which it will not only recommend but support very, very significantly to reduce the growth rate of entitlement programs across the board?

Mr. STOCKMAN. Well, Senator, I can answer that question by observing that I do not believe the administration has been unwilling to examine these areas. I think it has been the fact that over the last 2 years the Congress collectively, not a few members or one committee, but the Congress collectively, has been unwilling to demonstrate the will to deal with these programs. I hope that next year that disposition will change and I certainly know that the administration will be recommending and proposing measures to deal with the problem.

Senator GORTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Gorton.

I understand that Senator Hollings is willing to let us proceed with our time sequence.

Senator Riegle is next.

DISHONEST BUDGET PROJECTIONS

Senator RIEGLE. Thank you, Mr. Chairman.

I thank the Senator from South Carolina.

Mr. Stockman, we have an extremely serious problem today and that is you have brought us a dishonest budget projection and you did exactly the same thing last year. You came in with a dishonest budget resolution. I think it did great harm to the country and I think we lost a lot as a result of it and it has created a lot of suffering and you are doing precisely the same thing this year.

As a matter of fact, the figures are so dishonest that Murray Wiedenbaum is so embarrassed about them that he not only resigned but he made sure he was out of town on the day that these projections were released publicly.

The Treasury Secretary, Mr. Regan, also made sure that he did not comment on these figures. I am sure you saw what he said about that when he made a clever comment to sidestep the issue because he did not want to associate himself or his reputation with these projections. In today's Washington Post we have no one less than the Secretary of Commerce himself, to quote as follows—"Commerce Secretary Malcolm Baldrige said yesterday that next year's Federal deficit will be $20 to $30 billion larger than the administrations midyear economic review projected last week which is what you are bringing in here today. Baldrige became the first member of President Reagan's Cabinet to deal publicly with what many officials have been acknowledging privately."

Everyone in the country knows this, knows you are bringing in phony and dishonest and false figures, including members of the President's own Cabinet who within the last 24 hours have said so publicly.

My question to you is, how can we do a serious job here and how in fact can you even come in the door with figures that are so false and so inaccurate that even the top economic figures in the administration will not associate themselves with it? How do you expect

us to do this job? I think you have to take these numbers back. I think you have to go back and you have to convince people like the Secretary of Commerce and you have to come up with honest numbers and bring those honest numbers back here.

My question is, are you prepared to do that or are you going to ask us to deal with something that everybody knows is dishonest?

Mr. STOCKMAN. Well, Senator, let me observe that I get this lecture from you every time I come up here.

Senator RIEGLE. You deserve it every time because the problem repeats itself over and over again. You gave it to us last year. Everybody knows that. It is just that simple.

Chairman DOMENICI. Now, Senator, do you want him to reply?

Senator RIEGLE. Yes.

Chairman DOMENICI. Give him a chance to.

Senator RIEGLE. I am fully prepared to.

Mr. STOCKMAN. I explained what I thought were the differences between the CBO deficit projections for 1983 of $146 billion and ours of $115 billion, and I pointed out that only $8 billion of the difference is due to the economic forecast which is what you seem to be addressing in your question.

Senator RIEGLE. What is Mr. Baldrige talking about?

Mr. STOCKMAN. I am not sure what he is talking about. I think as you look at the economy, it is possible to say that there is a downside risk that economic performance will result in higher deficits over the next year. It is also possible to say, looking at the performance of the Congress and the amendment you intend to offer this afternoon to knock out $5 billion of savings that the Congress has agreed to adopt, that the downside risk on the deficit due to not implementing spending cuts and revenue increases is greater than the downside risk on the economic forecast.

Senator Riegle. Are we to believe him or are we to believe you? Are we to believe Malcolm Baldrige or David Stockman?

Mr. STOCKMAN. I would just say that these numbers are printed in the public record for anybody to analyze. Take a look at it and see where you disagree.

Senator RIEGLE. I am asking you now. We are hearing from two leading figures in the administration. You are saying one thing; he is saying something else. They are sharply different. Is he right or are you right?

Mr. STOCKMAN. Senator, I would say that given the economic uncertainties on the one hand and the legislative uncertainties on the other, anybody would be within their rights of saying the deficit could be $20 billion higher next year because we may get shortfalls on the economic side and we may get shortfalls on the policy side. This $20 billion is significant but it is not a large difference given the kind of budget and the kind of economy we are dealing with. I do not believe it raises to the level of the kind of moral issue that you are trying to create here and I wish we could a little more focus on what I would call the detailed technical, analytical evidence that is going behind these questions and fewer——

98-044 O - 82 -- 9

LID OFF ON DEFENSE SPENDING

Senator RIEGLE. Let us take one of them. Let us take defense, because that is on the front of the New York Times, that the 1984 budget request is reported to be 11 percent greater and if you throw in inflation on top of that, it is going to be 17.3 percent higher.

Now even you in the Atlantic Monthly article, and you have said it other times, that the defense budget in the outyears will not be nearly as low as we are showing here. You go on to say, it is a kind of swamp of $20 to $30 billion that can be ferreted out if you push hard enough.

Now, the lid is off on defense spending. Are you supporting that as well? Does it not matter how much we spend on defense?

Mr. STOCKMAN. The only defense budget before you is the 1983 request. You are cutting that request by $8.6 billion, which is precisely what a majority of the Congress decided to do. If you do not like the request next year, I presume the Congress retains the right to cut it and allocate the money somewhere else. It is the judgment of the President and the administration that such an action would be unwise.

Senator RIEGLE. It says—even your Defense Department official said today that the Reagan administration was undeterred by the vocal opposition to military spending and they were close to completing a military budget calling for $247 billion in outlays. Is that true or not? I am asking you, is that the truth? Is that a fact?

Mr. STOCKMAN. I think the truth is that the President has indicated that for the moment we will stick to the February number for 1984.

Senator Riegle. So this is not true?

Mr. STOCKMAN. Well, if the number for 1984 is $247 billion, which is the planning target for the Department, and that is what the——

Senator RIEGLE. So the lid is off? The lid is off on defense?

Chairman DOMENICI. Senator, your time has expired.

I would like to ask the Senators what they want to do.

First of all, Mr. Stockman, you did make a mistake in your testimony. You said Senator Riegle was going to offer a bill today to spend $5 billion more in the budget. He is not going to do that today. He is going to do that tomorrow. We want the record right.

We have to vote and we have four in a row. I am sure some people want to ask questions.

Do you want to return after the votes?

Senator KASTEN. I believe we should adjourn. We will be on the floor for approximately 1 hour and 15 minutes. If we would like other opportunities to ask Mr. Stockman some questions, he can come back another day.

Chairman DOMENICI. We are going to adjourn. We have the Secretary of the Treasury at 9:30 tomorrow. I apologize that Senators did not get notified about the 10 o'clock starting time today but tomorrow it is 9:30.

We will ask you to come back if the committee desires to have you.

[Whereupon, at 11:13 p.m., the committee adjourned.]

VIEWS OF THE SECRETARY OF THE TREASURY

WEDNESDAY, AUGUST 4, 1982

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 9:11 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Symms, Grassley, Quayle, Gorton, Hollings, Chiles, Biden, Johnston, and Riegle.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Lizabeth Tankersley, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The hearing will please come to order.

I am sure most of the Senators will be a little bit late. This meeting was scheduled for 9:30. We had a couple of options, one of which was to cancel it and do it next week. I thought it better to move it to nine. Senator Hollings concurred on the minority side, and all of this is because the Secretary unexpectedly has to be with the President at a Cabinet meeting at 11 o'clock. So, we will start, and as Senators arrive, they will be scheduled to take their 5 minutes.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Mr. Secretary, good morning to you. It is good to have you.

Since you were last here in February, Congress has taken the lead, at the direction of this committee, in adopting a first budget resolution which cuts future deficits by $379 billion over the next 3 years. Three-quarters of that effort was composed of further outlay reductions, pay cuts, and management and interest savings. The remaining $98 billion was tax increases and user fees, of which you are fully aware. These tax increases, as passed by the Senate, carefully preserve the marginal tax reduction of last year's bill while improving the basic fairness of the system by closing tax loopholes and improving compliance. Together these measures are the most stringent peacetime tightening of fiscal policy in about 50 years. Even with that, we are faced with deficits that are much higher than any of us would like to see.

Last Friday, the administration issued its midsession review of the budget and, yesterday, OMB Director Stockman appeared before this committee to discuss that document. In his testimony he made it quite clear that the administration unqualifiedly supports the budget policies contained in the first concurrent budget

resolution for 1983, particularly with regard to the reconciliation actions pending before Congress.

As you are certainly aware, Mr. Secretary, yesterday the Senate and the House began what our reports indicate will be a very difficult conference on the Tax Equity and Fiscal Responsibility Act. This bill passed the Senate by a narrow margin and, to date, the House has taken positions with respect to specific issues, and we are all aware of their positions at this point.

Much remains to be done. The scope of the conference is extremely broad. Negotiations this week and next will be difficult.

House passage is even more in doubt. I hope that in your remarks this morning, that you will reaffirm the administration's support for this legislation—both the tax and spending portions and that we, in Congress, who support this legislation will be able to count on your active assistance in expediting any issues that may arise in the course of the conference and as this legislation goes to final passage in both Houses.

I don't need to tell you how important it is to fulfill the budget decisions of the first budget resolution so that interest rates can come down in a permanent and sustainable way.

Now that we see the first glimmer of hope for an economic recovery, it is essential in my view that we not slacken our resolve to control Government spending and that we hang on to our hard won reduction in inflation. We cannot afford to have this recovery founder on higher year-end interest rates as some have predicted.

Obviously, we are on a very difficult course, Mr. Secretary. I am anxious to hear your views on where you see the economy headed and on these actions which are required of Congress now to see that the economy begins to grow in a balanced and durable way.

I would like to hear your thoughts on where we might end up and what the administration's feelings are on some items contained in that package. But for now I want to proceed to let you testify and then we will have some questions.

Mr. Secretary, I am pleased to have you here.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman, members of the committee.

It is a pleasure to meet with you today to discuss the budget outlook at midyear, the current state of the economy, and also progress to date in rebuilding a foundation for solid, sustainable, noninflationary growth in the years ahead.

This administration has presented its midyear assessment of the budget outlook. It is based on the same general economic assumptions that underlie the first concurrent budget resolution, updated for recent economic developments, though, because of time limitations, not for the recently released revisions to the national income and product accounts. Those assumptions were used so that our budget projections would be on a base comparable to those underlying the resolution. To do otherwise might tend to confuse rather than assist the debate on the crucial issue of outlay and deficit reduction.

Use of these economic assumptions does not necessarily imply our endorsement of those assumptions as a forecast or as policy goals. However, I do wish to go on record, along with the other members of the administration who have appeared before you, as wholeheartedly supporting the budget resolution and the very important task which it addresses of reducing the deficit.

LONGER PERSPECTIVE

So much of the dialog of late has centered on the immediate problems at hand, on the wiggles of the most recently released statistics, that it is easy to lose sight of the longer run fundamentals. A primary reason why President Reagan was elected by the American people 21 months ago was his promise to reverse the long-run pattern of steady deterioration of the Nation's economic performance.

It was our view, as well as that of many outside observers, that the weak performance of the economy resulted from: First, the erosion of incentives for risk taking, for formation of both physical and human capital, and for work effort generally, an erosion resulting from rising rates of taxation on both capital and labor; second, uncertainties and distortions generated by high and rising inflation; third, the massive interference of Government in the marketplace; and fourth, the Government absorption of a seemingly ever increasing share of the economy.

FUNDAMENTAL RESTRUCTURING

Upon coming to office, the administration set forth a program designed specifically to reverse the trends just outlined. Much of that program was enacted last summer in the form of the Economic Recovery Tax Act and the Omnibus Budget Reconciliation Act. Additional elements of our program of budget outlay reduction are currently before the Congress.

In setting forth our program, we did not expect overnight miracles. I said in congressional testimony in February 1981 that, and I quote myself, "We are proposing a bold new approach in economic policy, and we cannot expect to solve our problems overnight."

We knew that the process of bringing inflation under control and restoring vitality to the economy would be a difficult one. Admittedly, the road has been somewhat bumpier than many expected, and we are now undergoing a difficult period of transition. Much is yet to be accomplished, but already notable progress has been made toward achieving our longer run goals.

Inflation has been dramatically reduced. In the first half of this year, the Consumer Price Index increased by an annual rate of 5.1 percent, off from the increase of 8.9 percent during 1981, which, in turn, was down markedly from the 12.4 percent of 1980. Put in the context of the previous two recessions during which consumer price growth remained stuck at double-digit rates, this has been a considerable accomplishment. While some of the slowdown has reflected declining oil prices due to deregulation, the primary credit for the sharp deceleration goes to the policy of slow monetary growth supported by the administration.

Productivity jumped at a nearly 3-percent annual rate in the second quarter of this year, despite the fairly narrow increase in real economic activity, and even increased in the first quarter when the economy was declining sharply. This would signify that businesses have been taking vigorous actions to restore the competitive muscle of an earlier period.

With productivity rebounding, growth of unit labor costs in the business sector slowed to only a 4-percent rate in the second quarter. During 1979 and 1980, these unit labor costs had been rising at double-digit rates.

Interest rates, while still higher than we would like to see them, have come down substantially. This week, the Treasury auctioned 3-month bills at a yield of 9.6 percent—bank discount basis—the lowest auction average in nearly 2 years. That compares with a rate that reached 16.7 percent in mid-December 1980 and also again at one point in the spring of last year. The prime rate has come down to 15 percent, well below its late 1980 peak.

The personal saving rate recovered partially in 1981 to 6.4 percent, up 0.5 percentage point from the average of the prior 4 years.

SUPPLY-SIDE ECONOMICS AND THE ADMINISTRATION PROGRAM

The ultimate test of the administration program will be whether or not it can contain inflation and stimulate long-run economic growth. The current recession is a setback but not a permanent one. While the monetary authorities focus on the achievement of a low rate of inflation, fiscal policy improves incentives that stimulate saving and investment by raising their after-tax rates of return. Viewed in this light, the supply-side approach is not novel or revolutionary. Its gradual application is absolutely essential for the long-run health of the economy.

An incentive approach will work if it is given sufficient time. Indeed, if supply-side economics is interpreted broadly, rather than as the views of a particular economic school, there is no other sensible approach to the long-run performance of a market-oriented, free enterprise economy. Supply-side economics, under one name or another, has been with us since the time of Adam Smith at least, and will be with us in the future.

Mr. Chairman, I am skipping quite a bit in order to cut down on my reading time here.

If we persist in a steady course, the economy will right itself and move onto a sustainable growth track. Markets are in process of adjusting to the prospects of a noninflationary environment. They should be allowed to complete that adjustment. We do not want to repeat the mistakes of the past when stimulative actions were generally taken just as the economy was already turning around, leading eventually to inflationary excesses, and when programs were turned on rarely to be turned off, yielding a vastly expanded Government sector.

THE ECONOMY AT MIDYEAR

The economy appears to be in process of turning around. The first indication of recovery was contained in the increase in real GNP in the second quarter at an annual rate of 1.7 percent. Along

with nearly all forecasters in the private sector, we expect additional and more rapid expansion in the second half of the year. There are a number of signs pointing in that direction.

Businesses have been working off excess inventories at a rapid pace.

Production of consumer goods turned upward in April, following the inventory correction in that sector, and has increased at an annual rate of 5½ percent during the latest 3 months.

Interest rates have moved sharply lower during the past month. Businesses have been able to raise substantial funds in the medium-term market, as a first step in restructuring balance sheets.

It is my view that the recovery in the second half of this year and in the years thereafter will be at least in line with the path contained in the assumptions. It is a quite moderate recovery by historical standards and one that should be readily attainable.

Mr. Chairman, I brought with me today some charts. The projected path is shown in chart 1,[1] which also shows actual growth and inflation in 1980 and 1981.

REQUISITES TO A SUSTAINED RECOVERY

Further reductions in interest rates are crucial to a sustained recovery, and there are three requisites to lower interest rates.

The first is a steady course of monetary growth. The second requisite is convincing evidence that budget deficits are to be reduced in a steady, dependable fashion. For that reason, we fully support the first concurrent budget resolution and urge its rapid implementation.

In containing budget deficits, primary efforts should be directed at reducing outlays. In particular, raising revenues in a way that increases marginal tax rates and reduces the incentives enacted last year would be counter to long-run prospects for a healthy vital economy.

In this regard, the Senate Finance Committee is to be commended for crafting a bill which concentrates on enhancing compliance with current law and on loophole closing while largely leaving intact the structure of incentives contained in ERTA. Further, the Senate is to be applauded for passage of the tax bill. The administration generally supports this tax bill with suggestions for only minor modifications.

The proposed revenue increases will help reduce the deficit but will not significantly alter the thrust of the administration's program to return economic resources to the private sector.

If you will notice in chart 2,[2] Mr. Chairman, the revenue effects of the proposed legislation are contrasted with the much larger January 1981 tax cuts. You will notice in fiscal 1983, the first bar on the left is the 1981 tax cuts. Fourteen percent of that tax cut went to business; 86 percent went to individuals. If you look at the one on the right, just below it, that is the 1982 revenue increase—the 18 percent, portion represents new tax provisions, the 39 per-

[1] See p. 144.
[2] See p. 145.

cent represents loopholes and excesses that are being closed in this bill; and the 43 percent, represents greater compliance measures, that is, increases from withholding on interest and dividends and things of that nature. Similar comparsions are made for 1984 and 1985.

Now, a third requisite is to insure that individual marginal tax rates are not allowed to rise. Marginal tax rates to the average worker are already excessive. A median income worker now faces tax rates of 40 to 44 percent on additional income, after inclusion of social security and State and local taxes. In the late 1960's, marginal rates were 26 to 30 percent.

It is also crucial that businesses and workers be able to plan ahead with the knowledge that the Tax Code will not be substantially altered in future years and that tax rates will not be pushed up by bracket creep.

Indexing, to be implemented in 1985, is one step in the direction of removing uncertainty from economic decisionmaking. It is also important that businesses be able to make plans based on knowledge of rates of depreciation and investment credits that will be in effect in future years.

THE MID-SESSION REVIEW BUDGET TOTALS

We believe budget figures presented in the Mid-Session Review are consistent with a strong, sustained economic recovery. Revenues as a share of GNP move down to our target of 19 to 20 percent. The outlay share of GNP declines to a little over 20 percent toward the end of the forecast period and is on a downward path.

Deficits decline steadily. The profile of the ratio of deficits, both on and off budget, to GNP is shown in chart 3.[1]

Now, you will notice in chart 3 that budget deficits during the period 1975, 1976 and 1977 were in the 3 percent to 4, 4½ percent range. In 1982, we are projecting them as just over 4 percent, and then on the downward path in the forecast period coming down each year to where they eventually end up at a little under 1½ percent.

By 1985, the deficit is projected to be 2.1 percent of GNP. There was only 1 year, from 1975 through 1981, in which the share was lower. The share is projected to decline in 1986 and again in 1987 when it reaches 1.4 percent.

The absolute magnitudes of the midsession budget deficits are shown in chart 4 [2] along with the original administration budget estimates of February 1981. Now, you will notice the changes in those estimates. In 1981 projecting for fiscal 1982, we said there would be a budget deficit of $45 billion. It has now come to $109 billion, our estimate for September 30, 1982, the end of this current fiscal year. Of that, $32 billion is due to lower real growth caused by the recession; $16 billion reflects increased interest payment because interest rates have stayed remarkably high during this period; $16 billion is from lower inflation. That is called the penal-

[1] See p. 146.
[2] See p. 147.

ty of success. Because we got inflation down, along with it came less revenue.

Such deficit should be readily manageable. The Commerce Department, as part of its regular July revisions, recently marked up the share of savings in the economy. For 1981, the share of gross private saving in GNP is now placed at 17.2 percent, up nearly 1 full percentage point from the previously estimated figure. Even if there were to be no further improvement in that ratio, which is an unlikely occurrence, the deficit in fiscal 1983, both on and off budget, would represent just 23 percent of gross private saving, and by 1985 the figure would be only 12 percent.

There is, of course, some variation in the budget deficit estimates, depending upon economic assumptions and concept.

In chart 5,[1] the Congressional Budget Office projects deficits of some $150 billion in each of the next 3 fiscal years. The administration projects lower and steadily declining deficits on the basis of somewhat less pessimistic assumptions than those used by the CBO. The budget deficits are much smaller and virtually gone by 1985 on the high employment basis which was widely used by previous administrations. It adjusts the budget totals to remove the temporary effects of recession.

Mr. Chairman, I think you can see that pretty readily. Taking the concept of a full employment budget by 1985 there would be virtually no deficit, on a full employment basis.

THE OUTLOOK

We are becoming increasingly confident that the economy is entering into a period of sustained recovery in which inflation, interest rates, and unemployment will all be moving downward. It is important that this recovery be steady and long lived. There were wide swings in economic activity, in price levels, and in interest rates over the past decade, many of them traceable to shifts in Government policy. These swings have left legacies of uncertainty and hesitancy and of underutilized resources. These can be overcome only by a prolonged period of steady expansion.

Attainment of our goals will require steady, evenhanded application of policy by the administration, the Congress, and in the area of monetary policy by the Federal Reserve. It will require that deficits be steadily reduced and that the burden of Government in the overall economy be pared back. In this regard, I wish to commend this committee for its exceptional efforts which led to passage of the first concurrent resolution. I urge its speedy implementation.

Mr. Chairman, I will now be glad to answer questions you or any member of the committee will have.

Chairman DOMENICI. Thank you. Your statement will be made a part of the record. Where you did not read it, it will be inserted at this point.

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[1] See p. 148.

For Release Upon Delivery
Expected at 9:00 a.m., E.D.T.
August 4, 1982

STATEMENT OF
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE
THE SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the budget outlook at midyear, the current state of the economy, and also progress to date in rebuilding a foundation for solid, sustainable, noninflationary growth in the years ahead.

This Administration has presented its midyear assessment of the budget outlook. It is based on the same general economic assumptions that underlie the First Concurrent Budget Resolution, updated for recent economic developments, though, because of time limitations, not for the recently released revisions to the national income and product accounts. Those assumptions were used so that our budget projections would be on a base comparable to those underlying the Resolution. To do otherwise might tend to confuse rather than assist the debate on the crucial issues of outlay and deficit reduction.

Use of these economic assumptions does not necessarily imply our endorsement of those assumptions as a forecast or as policy goals. However, I do wish to go on record, along with the other members of the Administration who have appeared before you, as wholeheartedly supporting the Budget Resolution and the very important task which it addresses of reducing the deficit.

R-899

A Longer Perspective

So much of the dialogue of late has centered on the immediate problems at hand, on the wiggles of the most recently released statistics, that it is easy to lose sight of the longer-run fundamentals. A primary reason why President Reagan was elected by the American people twenty-one months ago was his promise to reverse the long-run pattern of steady deterioration of the nation's economic performance. To review briefly that record of deterioration:

- During the 1960s the nation's real gross national product increased by a yearly rate of 4.2 percent. In the 1970s this rate was only 3.1 percent and during the two years ending late 1980 it grew hardly at all -- by less than 1/2 percent per year.

- The consumer price index increased by little more than 2 percent per year across the two decades of the 1950s and 1960s, though beginning to accelerate late in the 1960s. During the 1970s, it rose by a 7.1 percent rate, and it soared by 12.9 percent a year during the two years ending December 1980.

- Productivity, or output per workhour, in the total business sector of the economy increased by 3.1 percent a year during the 1950s and 1960s but only by 1.6 percent a year during the 1970s. At the end of 1980, productivity was lower than it had been three years earlier in 1977.

- The personal saving rate, which had averaged 7.7 percent for the ten years 1966 through 1975, fell to an average of only 5.9 percent for the period 1977 through 1980.

- The real net fixed capital stock of the nation's businesses grew at a yearly rate of 4.6 percent during the 1960s, but by the latter part of the 1970s, this rate of growth was down to only 3.2 percent. This was little more than the growth of the nation's labor force so that there was hardly any increase in capital per worker.

- The unemployment rate averaged 4.5 percent during the 1950s, 4.8 percent during the 1960s, but 6.2 percent during the 1970s. It was 7.6 percent during the last half of 1980. Because of the recession, more recently it mounted even higher.

- Interest rates rose steadily. In 1959, the prime rate charged by banks was 4.5 percent. A decade later the rate was 8.0 percent, and in 1979 the figure was 12.7 percent. In December 1980 the prime hit an unprecedented 21.5 percent.

This record is familiar to all. It perhaps has been cited ad nauseam, but it is cited here once again because it is so easy to become transfixed by the problems immediately at hand and to lose sight of the need for a fundamental restructuring, as evidenced by that historic record.

It was our view, as well as that of many outside observers, that the performance just outlined resulted from (1) the erosion of incentives for risk taking, for formation of both physical and human capital, and for work effort generally, an erosion resulting from rising rates of taxation of both capital and labor; (2) the uncertainties and distortions generated by high and rising inflation; (3) the massive interference of government in the market place; (4) and government absorption of a seemingly ever increasing share of the economy.

A Fundamental Restructuring

Upon coming to office the Administration set forth a program designed specifically to reverse the trends just outlined. Much of that program was enacted last summer in the form of the Economic Recovery Tax Act and the Omnibus Budget Reconciliation Act. Additional elements of our program of budget outlay reduction are currently before the Congress.

In setting forth our program, we did not expect overnight miracles. I said in Congressional testimony in February 1981 that "We are proposing a bold new approach in economic policy, and we cannot expect to solve our problems overnight."

We knew that the process of bringing inflation under control and restoring vitality to the economy would be a difficult one. Admittedly, the road has been somewhat bumpier than many expected, and we are now undergoing a difficult period of transition. Much is yet to be accomplished, but already notable progress has been made toward achieving our longer-run goals.

- Inflation has been dramatically reduced. In the first half of this year, the consumer price index increased by an annual rate of 5.1 percent, off from the increase of 8.9 percent during 1981, which, in turn, was down markedly from the 12.4 percent of 1980. Put in the context of the previous two recessions during which consumer price growth remained stuck at double-digit rates, this has been a considerable accomplishment. While some of the slowdown has reflected declining oil prices due to deregulation, the primary credit for the sharp deceleration goes to the policy of slow monetary growth supported by the Administration.

- Productivity jumped at a nearly 3 percent annual rate in the second quarter of this year, despite the fairly narrow increase in real economic activity, and even increased in the first quarter when the economy was declining sharply. This would signify that businesses have been taking vigorous actions to restore the competitive muscle of an earlier period.

- With productivity rebounding, growth of unit labor costs in the business sector slowed to only a 4 percent rate in the second quarter. During 1979 and 1980, these unit labor costs had been rising at double-digit rates.

- Interest rates, while still higher than we would like to see them, have come down substantially. This week, the Treasury auctioned 3-month bills at a yield of 9.6 percent (bank-discount basis), the lowest auction average in nearly two years. That compares with a rate that reached 16.7 percent in mid-December 1980 and also again at one point in the spring of last year. The prime rate has come down to 15 percent, well below its late 1980 peak.

- The personal saving rate recovered partially in 1981 to 6.4 percent, up 0.5 percentage point from the average of the prior four years. Since October when the initial stage of the personal tax reductions went into effect the rate has averaged 6.9 percent.

- A spirit of venture capital is in the process of being restored to the economy. One measure is the number of new unseasoned common stock issues. These doubled in 1981 in both number and dollar volume (the latter to $3.3 billion) following even larger percentage increases in 1980 after the 1979 reductions in the capital gains tax rates had gone into effect.

Those facts represent solid accomplishments, but they are only the initial dividends from the program. Clearly the economy has not performed this year or last as we would have liked, but we believe that we can build on these initial steps and that dividends will accrue more rapidly in the future. Now is not the time to reverse course, to declare the battle lost while it is only in its initial stages and as the first evidence is beginning to come in portending ultimate success.

Supply-Side Economics and the Administration Program

The ultimate test of the Administration program will be whether or not it can contain inflation and stimulate long-run economic growth. The current recession is a setback but not a permanent one. While the monetary authorities focus on the achievement of a low rate of inflation, fiscal policy improves incentives that stimulate saving and investment by raising their after-tax rates of return. Viewed in this light, the supply-side approach is not novel or revolutionary. Its gradual application is absolutely essential for the long-run health of the economy.

An incentive approach will work if it is given sufficient time. Indeed, if supply-side economics is interpreted broadly, rather than as the views of a particular economic school, there is no other sensible approach to the long-run performance of a market-oriented, free enterprise economy. Supply-side economics, under one name or another, has been with us since the time of Adam Smith at least, and will be with us in the future.

Long-Run Solutions to Long-Run Problems

Those who are impatient demand that we reverse direction. However, the Administration program was designed to provide solutions for the longer-term drift toward economic stagnation which marked the past decade or more. With evidence emerging that the program is beginning to have its intended effects, now is not the time to throw it over in search of some quick fix that will provide temporary relief. Now is a time to construct a long-term foundation, not a quick fix. We have searched the record of "mid-course corrections" of previous administrations: the on-off tax surcharge and removal and reinstatement of the investment tax credit of the late 1960s and early 1970s, the imposition of wage-price controls, the credit controls of 1980. Each was accompanied by swings in monetary policy. Each was counterproductive,

in that it set off a chain of events that was unforeseen -- series of unproductive transactions to escape wage-price controls in one case, a dramatic slide in consumer purchases on credit and in the economy in another. Each heightened the uncertainties in the market place, with long-run debilitating effects.

Some would have us ask the Federal Reserve to turn the monetary spigots back on in order to bring interest rates down. Such a course would be self-defeating. Any impact on interest rates would be ephemeral at best, and might well have the opposite effect from that desired, as it would be evident that the economy would again be moving back onto the inflation treadmill.

If we persist in a steady course, the economy will right itself and move onto a sustainable growth track. Markets are in process of adjusting to the prospects of a noninflationary environment. They should be allowed to complete that adjustment. We do not want to repeat the mistakes of the past when stimulative actions were generally taken just as the economy was already turning around, leading eventually to inflationary excesses, and when programs were turned on rarely to be turned off, yielding a vastly expanded government sector.

The Economy at Midyear

The economy appears to be in process of turning around. The first indication of recovery was contained in the increase in real GNP in the second quarter at an annual rate of 1.7 percent. Along with nearly all forecasters in the private sector, we expect additional and more rapid expansion in the second half of the year. There are a number of signs pointing in that direction.

- Businesses have been working off excess inventories at a rapid pace. The ratio of real nonfarm inventories to real final sales of goods and services by business in the second quarter was lower than had been averaged in any year since 1973. Not generally recognized, the recent downturn was largely one of inventory correction. From the third quarter of last year to the first of 1982, real business inventory investment dropped by $32 billion (1972 dollars), or the major portion of the $40 billion decline in real GNP during that period.

- Production of consumer goods turned upward in April, following the inventory correction in that sector, and has increased at an annual rate of 5-1/2 percent during the latest three months, with most consumer goods industries contributing to that rise. The reduction in personal tax withholding rates at the first of this month came at a propitious time. It will help sustain the consumer sector, which typically is one of the sectors which leads the economy out of periods of downturn.

- Interest rates have moved sharply lower during the past month. Businesses have been able to raise substantial funds in the medium-term market, as a first step in restructuring balance sheets.

The economic assumptions underlying the Mid-Session Review do not necessarily correspond with views within the Administration. However, it is my view that the recovery in the second half of this year and in the years thereafter will be at least in line with the path contained in the assumptions. It is a quite moderate recovery by historical standards and one that should be readily attainable. Real growth would average close to 4 percent annually from 1983 through 1985 and inflation would be in the 6 to 6-1/2 percent range. The projected path is shown in Chart 1 which also shows actual real growth and inflation in 1980 and 1981.

The most recent inflation statistics have not been encouraging. The consumer price index rose by 1.0 percent in both May and June. However, that appears to have been a temporary phenomenon related for the most part to transitory factors in energy and food prices. It will shortly run its course, and price series should be growing only moderately later in the year. The inflation spiral appears to have been largely broken.

Requisites to a Sustained Recovery

Further reductions in interest rates are crucial to a sustained recovery, and there are three requisites to lower interest rates. The first of these is a steady course of monetary growth. The evidence indicates that a substantial uncertainty premium is imparted to interest rates by volatility of money. As an example of this volatility, money supply (M1) grew at a rapid 15 percent annual rate between October of last year and January followed by growth of only a 1-1/2 percent rate during the next five months, including declines in May and June.

However, at the July 21 level, the money supply was $2.1 billion below the upper boundary of the Fed's long-run target range. As the Fed repeatedly demonstrates its ability to meet its target, market confidence will increase, and fear of inflation and sudden jumps in interest rates will subside. In the past, moderate and steady growth of money has led to low interest rates. We believe that steady money growth at the upper end of the Fed's target range, at a rate of between 5 and 5-1/2 percent, will bring interest rates down and promote a solid and sustainable recovery.

The Federal Reserve has announced its intention to move toward a more contemporaneous reserve accounting. This is a welcome step which we hope will be implemented at an early date. With or without contemporaneous reserve accounting, however, we believe more can be done to impart stability to the growth of monetary aggregates, and it is urgent that steps be taken in that direction.

The second requisite for lower interest rates is convincing evidence that budget deficits are to be reduced in a steady, dependable fashion. For that reason, we fully support the First Concurrent Budget Resolution and urge its rapid implementation. In containing budget deficits, primary efforts should be directed at reducing outlays. In particular, raising revenues in a way that increases marginal tax rates and reduces the incentives enacted last year would be counter to long-run prospects for a healthy, vital economy. In this regard, the Senate Finance Committee is to be commended for crafting a bill which concentrates on enhancing compliance with current law and on loophole closing while largely leaving intact the structure of incentives contained in ERTA. Further, the Senate is to be applauded for passage of the tax bill. The Administration generally supports this tax bill with suggestions for only minor modifications.

The proposed revenue increases will help reduce the deficit but will not significantly alter the thrust of the Administration's program to return economic resources to the private sector. Revenue effects of the proposed legislation are contrasted in Chart 2 with the much larger 1981 tax cuts.

A third requisite is to insure that individual marginal tax rates are not allowed to rise. The individual income tax cuts that have gone into effect in 1981 and 1982 do not keep the taxpayer even with the effects of inflation-induced bracket creep in those two years. Only in 1983 will there be true tax reduction for American families. Marginal tax rates to the average worker are already excessive. A median income worker now faces tax rates of 40 to 44 percent on

98-044 O - 82 -- 10

additional income, after inclusion of social security and state and local taxes. In the late 1960's marginal rates were 26 to 30 percent.

It is also crucial that businesses and workers be able to plan ahead with the knowledge that the tax code will not be substantially altered in future years and that tax rates will not be pushed up by bracket creep. Indexing, to be implemented in 1985, is one step in the direction of removing uncertainty from economic decision-making. It is also important that businesses be able to make plans based on knowledge of rates of depreciation and investment credits that will be in effect in future years.

The Mid-Session Review Budget Totals

We believe budget figures presented in the Mid-Session Review are consistent with a strong, sustained economic recovery. Revenues as a share of GNP move down to our target of 19 to 20 percent. The outlay share of GNP declines to a little over 20 percent toward the end of the forecast period and is on a downward path.

Deficits decline steadily. The profile of the ratio of deficits, both on and off budget, to GNP is shown in Chart 3. By 1985, the deficit is projected to be 2.1 percent of GNP. There was only one year from 1975 through 1981 in which the share was lower. The share is projected to decline in 1986 and again in 1987 when it reaches 1.4 percent.

The absolute magnitude of the Mid-Session budget deficits is shown in Chart 4 along with the original Administration budget estimates in February 1981. Lower real growth because of the recession, higher interest rates, and lower inflation account for the rise in the estimated deficits as shown in the chart.

Such deficits should readily be manageable. The Commerce Department, as part of its regular July revisions, recently marked up the share of savings in the economy. For 1981, the share of gross private saving in GNP is now placed at 17.2 percent, up nearly one full percentage point from the previously estimated figure. Even if there were to be no further improvement in that ratio, an unlikely occurrence, the deficit in FY-1983, both on and off budget, would represent just 23 percent of gross private saving and by FY-1985 the figure would be only 12 percent. In dollar terms in 1985, on that constant share basis the $85 billion deficit now projected, including off-budget outlays, would compare with gross private

savings of more than $700 billion. Projection of increases in the saving share would be more realistic, based on the improvement we foresee from currently depressed levels in corporate profitability and in retained earnings, the effects of ACRS, the already enacted incentives for increased personal saving, and the increased depreciation allowances to be thrown off by rising capital spending later in the period. Deficits of the size projected in the years ahead should be managed without financial strains.

There is, of course, some variation in the budget deficit estimates depending upon economic assumptions and concept. As shown in Chart 5, the Congressional Budget Office projects deficits of some $150 billion in each of the next three fiscal years. The Administration projects lower and steadily declining deficits on the basis of somewhat less pessimistic assumptions than those used by CBO. Budget deficits are much smaller and virtually gone by FY 1985 on the high employment basis which was widely used by previous Administrations. It adjusts the budget totals to remove the temporary effects of recession.

Outlook

We are becoming increasingly confident that the economy is entering into a period of sustained recovery in which inflation, interest rates, and unemployment will all be moving downward. It is important that this recovery be steady and long-lived. There were wide swings in economic activity, in price levels, and in interest rates over the past decade, many of them traceable to shifts in Government policy. These swings have left legacies of uncertainty and hesitancy and of underutilized resources. These can be overcome only by a prolonged period of steady expansion.

Attainment of our goals will require steady, evenhanded application of policy by the Administration, the Congress, and in the area of monetary policy by the Federal Reserve. It will require that deficits be steadily reduced and that the burden of government in the overall economy be pared back. In this regard, I wish to commend this Committee for its exceptional efforts which led to passage of the First Concurrent Resolution. I urge its speedy implementation.

Chart 1

DECLINING INFLATION AND RESTORATION OF REAL GROWTH

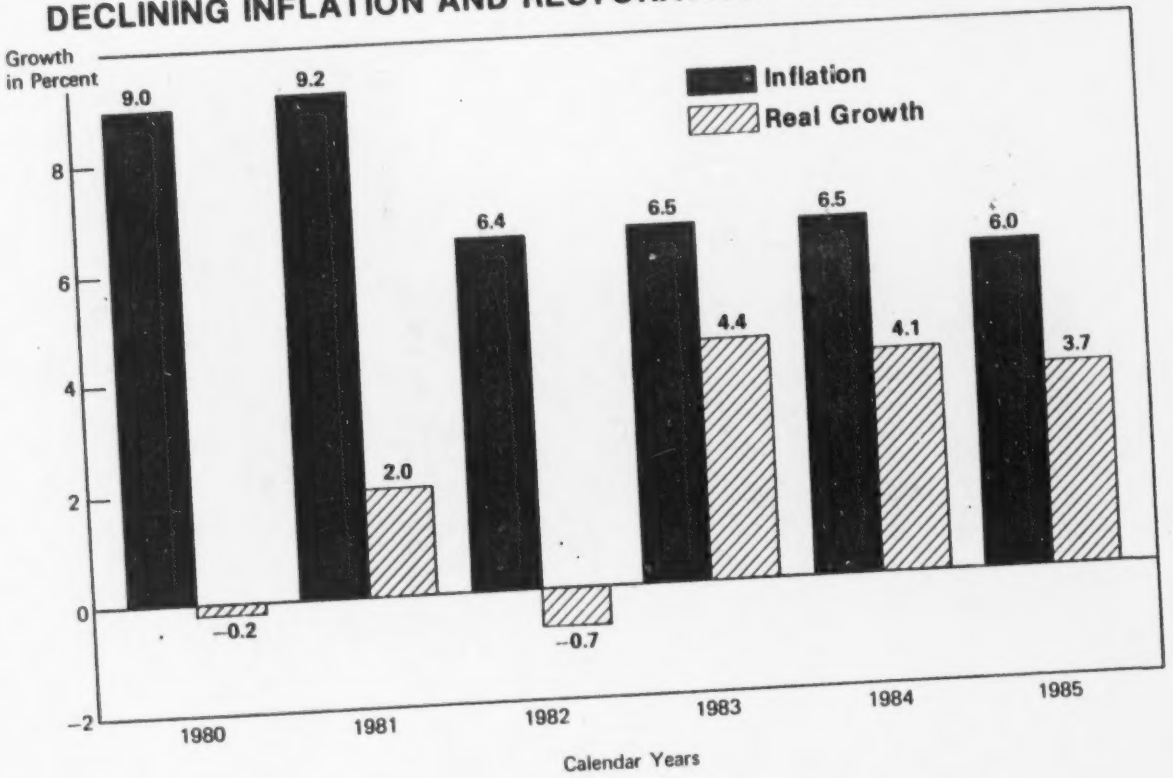
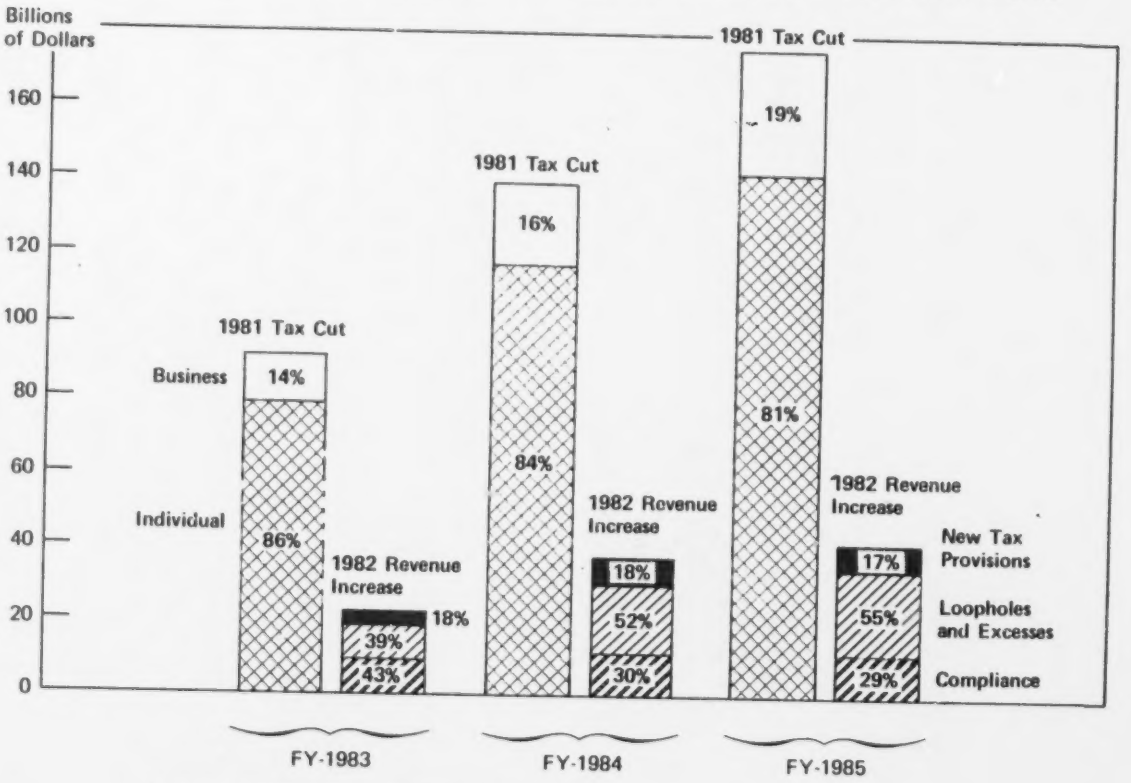


Chart 2

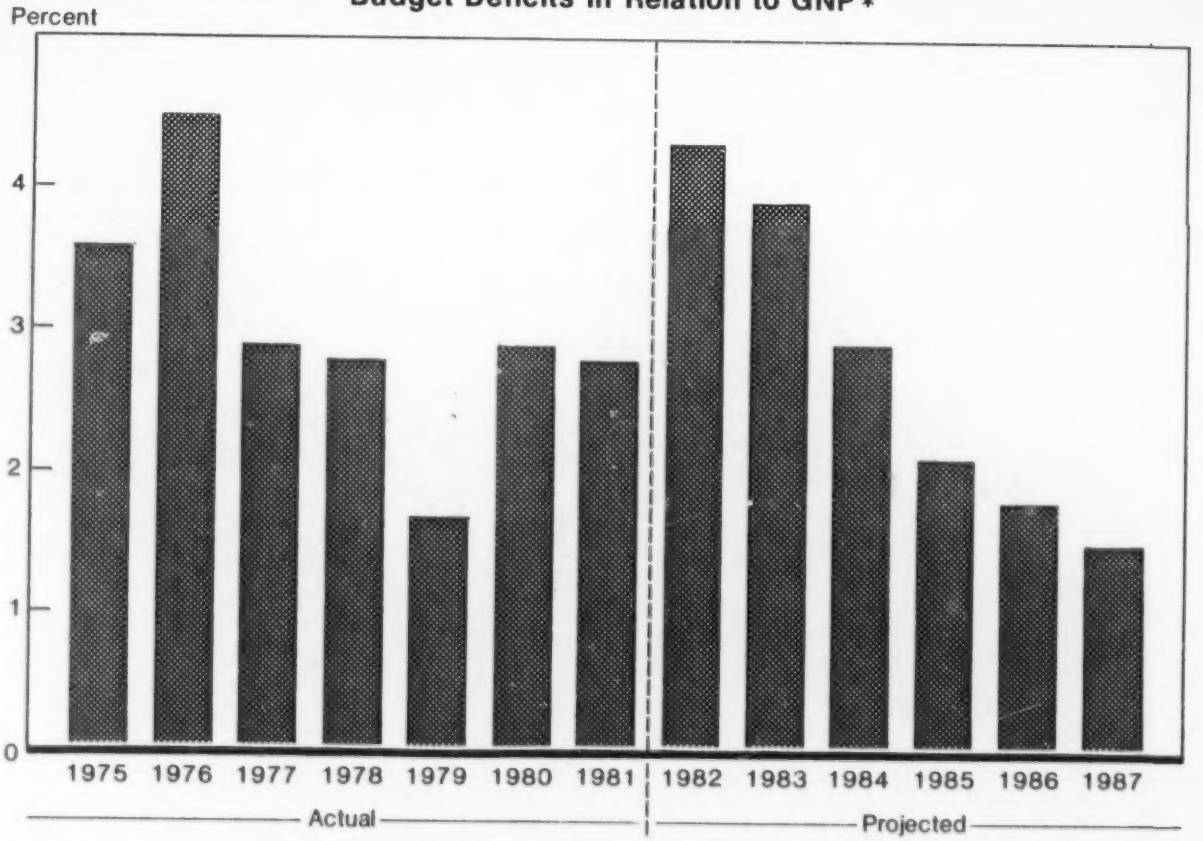
REVENUE EFFECTS OF THE 1981 TAX CUT VS. H.R. 4961*



* Tax cuts in 1981 Economic Recovery Tax Act and revenue enhancement measures in 1982 H.R. 4961

Chart 3

Budget Deficits in Relation to GNP *



* On and off budget as percent of fiscal year GNP.

July 23, 1982-A112

Chart 4

CHANGE IN DEFICIT ESTIMATE

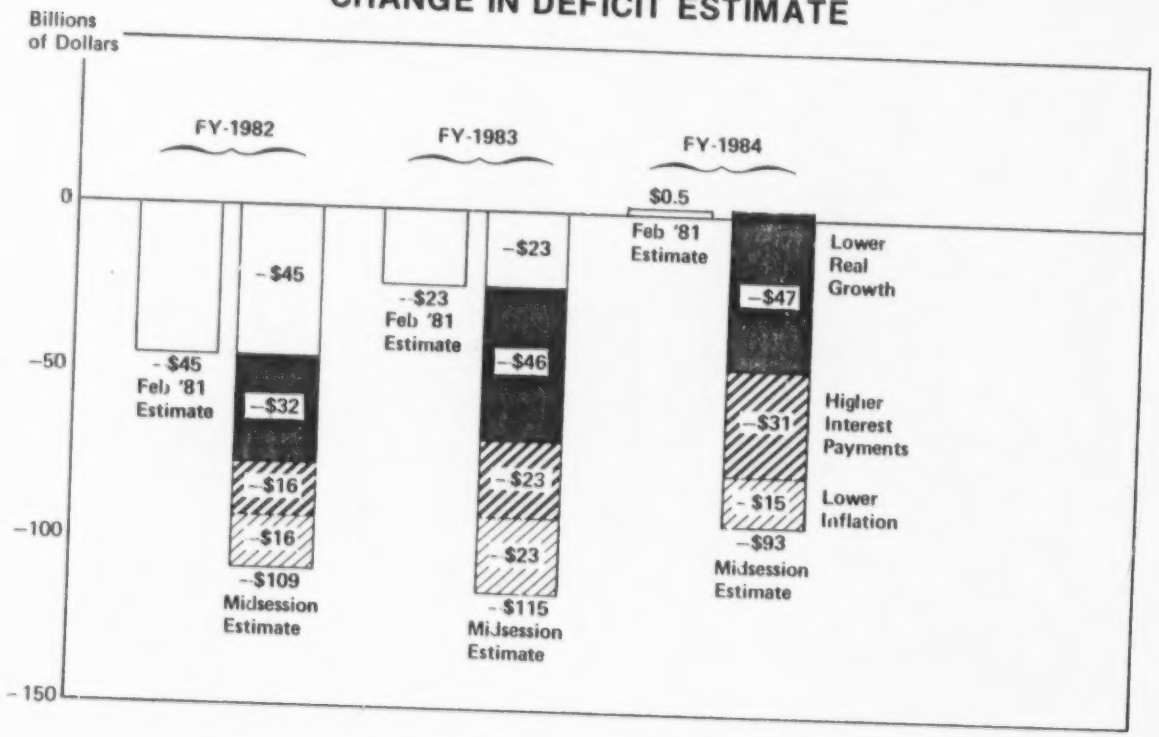
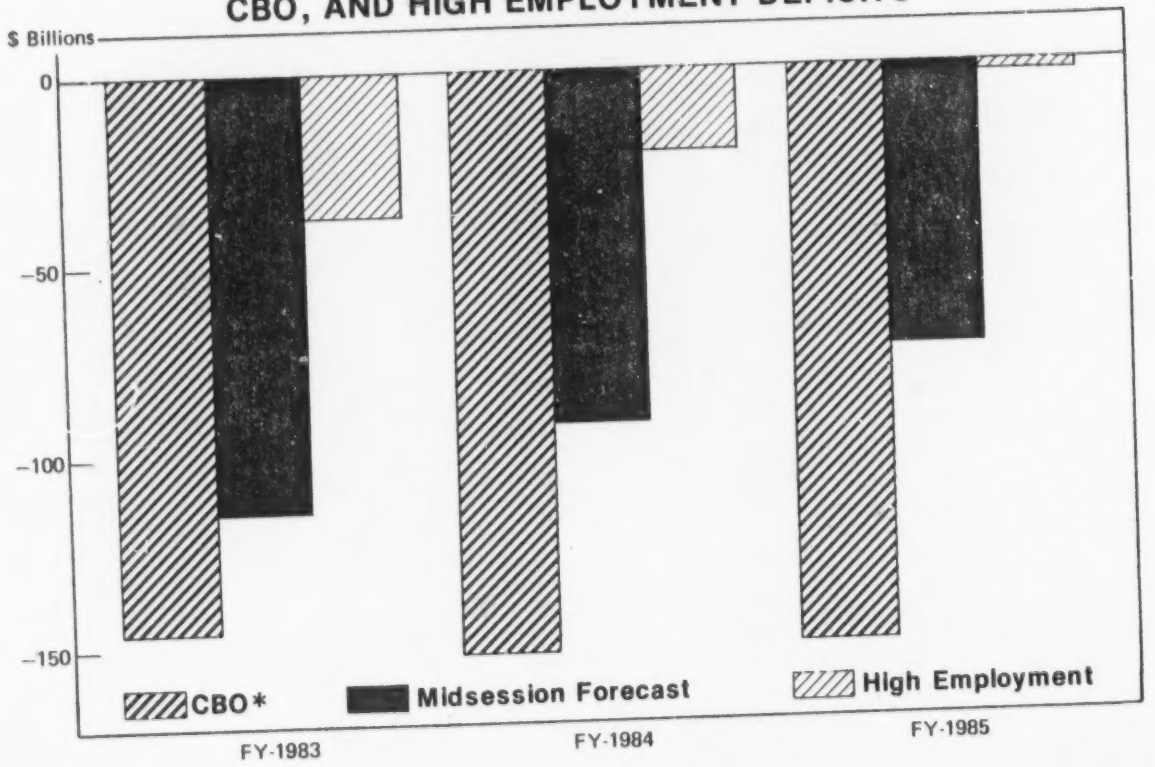


Chart 5

PROJECTED MIDSESSION, CBO, AND HIGH EMPLOYMENT DEFICITS



* CBO estimates are midpoints of ranges.

FAILURE TO PASS TAX AND SPENDING REQUIREMENTS WOULD BE DISASTROUS

Chairman DOMENICI. In your view, Mr. Secretary, what would be the consequences if Congress failed to pass the tax and spending requirements in the reconciliation bill?

Secretary REGAN. It would be quite disastrous, I think, Mr. Chairman. Notice what would happen. Regardless of whether you are using the CBO figure or using the midsession review figures, the budget deficits at that point would have to be somewhere in the neighborhood of $165 to $175 billion without any of these policy changes of spending cuts or tax revenue increases. Such deficits would literally throw the financial markets into chaos, I believe. They have figured now into their thinking that we are going to have some type of budget cuts and that we are going to have some type of revenue increases. As a result, interest rates have started moving downward. We would hope they continue on that path. But if Congress were to fail in meeting these challenges, I am afraid that the markets would turn around, rates would go the other way.

Chairman DOMENICI. Last Wednesday, it is my understanding, you announced intentions to finance almost $100 billion in new Treasury debt through the second half of 1982. Can we do this without driving up interest rates? We have good news on the interest side and exceedingly good news the last few weeks. Will interest rates go up when you get into the market with that $100 billion, or will they continue to come down?

Secretary REGAN. The interesting thing to me was, Mr. Chairman, right after we made the announcement, rates started down, contrary to the opinion of most people who said $100 billion would so frighten the market that interest rates would go up. I think the answer is that the marketplace feels that they can adjust. Business demand probably over the next 6 months will not be that great.

As I said in my prepared remarks, we know from the revised figures that savings have increased. I believe the marketplace thinks that we can finance the amount we have announced, provided that that is all we have to finance. Were we to have to finance $150 billion, for example, in that period, that would be something else again.

Chairman DOMENICI. I am going to yield to Senator Hollings, Senator Gorton, and I will return. I will ask some questions at the end.

LITTLE INSTITUTIONAL MEMORY AROUND TOWN

Senator HOLLINGS. Thank you, Mr. Chairman.

Mr. Secretary, the mention of a penalty of success in describing the economic dilemma we are in awakens you early this morning. We have very little institutional memory around this town.

You talk now and make a chart about full employment budgets. I wish Clifford Case were here. I will never forget the cross examination of Paul McCracken. We never heard of such nonsense.

This brings back memories. We had that balanced budget in 1968–69 and we practically had one in 1970. Along came Paul McCracken and the Nixon administration and the full employment budget, and by 1973 we had $45 billion deficit, spending money we

did not have. Send that fellow back to where Nixon is or somewhere else. That is a reckless fiscal policy that breaks fiscal discipline whatever when you start talking in those terms.

Secretary REGAN. You will notice that we did not support it and I very carefully disassociated myself from it.

Senator HOLLINGS. You have a chart but you disassociate yourself with the chart.

Secretary REGAN. In previous administrations, that was a way of looking at things. We decided out of curiosity to show it. We did not advocate it, and I agree with you, it is not part of our lexicon nor should it be.

Senator HOLLINGS. Let us both be optimistic and say the tax bill passes, even though we could give the same answer whether the tax bill passes or not. We are still in serious trouble with $145 billion deficit facing us. Very little will happen, on account of the politics on both sides of the aisle between now and the election.

POST-ELECTION SESSION

Do you think we should have a post-election session and see what we can do?

Secretary REGAN. I would be guided more on that by what happens to the budget cuts and to the tax bill itself over the next couple of months.

Senator HOLLINGS. You see what is in the cards. We have about 30 working days left. We break around August 20. In the time that is left in September, from the first of September to October, nothing will happen to that budget. It may slip a little. You might not get the tax increase or you might get it. But either way, you still have this horrendous budget deficit, and that is what the market is counting on and that is why it is nervous, because it does not look as if anything is being done. You must know that because you were a leader of the business community and you have many intimate friends.

What I am getting to is it seems to me that if we can get an agreement that we can go back to some kind of freeze right after the election and have a meaningful post-election session, we could give this country the hope which it deserves. Senator Gorton, Senator Domenici, and all of us have an approach of this kind. Is it not interesting that you can, without cutting spending and without increasing taxes, package together a program to just stop the increases, and share $187 billion over the next 3 years. We can save $187 billion that need not be spent. Now, I know the ideology that says that that assumes that when we talk about tax spending, that the Government owns the money and it is going to give it back. We do not have the money. We are running a $116 billion deficit. So when we gave the tax cuts the first of last month, we went out and borrowed it. And next July 1983, according to your charts, we do not have the surplus money to cut taxes by 10 percent.

FREEZE ACROSS BOARD FAIRER

So, in reality, we are looking at whether or not we are going to borrow over that 3-year period $76 billion bucks and similarly with defense spending. You know, we can have a total freeze on spend-

ing and taxes. A 3-percent real growth in defense will and save $45 billion. You can save another $23 billion on entitlements.

We are going to have to do something on social security. You must have a freeze now. The system broke and is borrowing from the health fund.

So we should at the top level effectuate some kind of discipline on the budget and taxes, rather than racing around the country from pillar to post on all these peripheral problems. The solution is not a constitutional amendment to balance the budget. It is not a resolution on the Federal Reserve. Everybody flagellates around and acts like they are doing something. It is biting that bullet of a freeze across the board that is fairer, that is a shared sacrifice, and you do not have to cut any spending.

Do you think it is in spending cuts? I worked with you and the gang of 17. We nickel and dimed over a dozen meetings. If you take the 1985 budget, your 1985 budget, according to these charts, defense is $300 billion, social security is $200 billion. Health costs, medicare, medicaid, $100 billion. You got the cost of interest on the national debt going to $140 billion and $25 billion for veterans. That is $765 billion. In your revenue charts you show only $760 billion. There is no use in misleading the country for the next 2 or 3 months. Then you get the media and poor little David Stockman came in and told us to tighten our belts. That is nonsense. It is outrageous. Where is the tightening of the belt? You have $765 billion in spending and you only have $760 in receipts. You can eliminate the FBI, the Customs, Treasury, the Congress and still not balance the budget.

We are on a collision course. That light at the end of the tunnel is a train headed directly on the track at us. You know and I know it but we are not willing to tell anybody or to talk sense between now and the election. You are the Secretary of the Treasury. You are a responsible businessman. You got to talk to the President and sober him up, get him back on track because this is a binge the country cannot afford.

Secretary REGAN. Well, Senator, I would take exception to the last couple of remarks of yours. I think the President does understand the seriousness of it. He has indicated that he wants the Congress to come to grips with this budget problem. I agree with you, there are certain things built into the budget that we have to deal with. Whether or not we can do it as you suggest in a postelection lame duck session of Congress, I am not sure. I have heard the majority leader says that in his judgment of years in the Congress, most of the lame duck sessions are not that productive. Nonetheless, why can we not do it before the Congress adjourns? Why is it not reasonable to expect that if the Congress can do it in November that they would not do it in August or September?

PRESIDENT SHOULD LEAD THE WAY

Senator HOLLINGS. Let me stop you. If the President led the way, if the President came on TV at 8 o'clock tonight and outlined what I said, he would be a hero. He would give Reaganomics a chance.

Point 2, on the lameduck session, we came last year with a lameduck Senate and a lameduck House and a lameduck Democratic

President and passed the first reconciliation bill less than 2 years ago. We listened to the people speak.

With respect to taking exception to what I said, I was dead serious about it. How can you get the Congress to cut when you cannot get savings from your own Defense Department? How can you get them to effect discipline when the President is trying to cut, let us say, education grants while also giving the church leaders tuition tax credits, starting new programs for private education, and taking away from the disadvantaged and giving to the advantaged? It is not working. It is not selling. You are not doing it. He is leading in the opposite direction. He is telling everybody that everything is fine, that prosperity is around the corner. He is starting new education programs and do not worry, we are going to spend more on defense. Budgets do not mean anything. But, yes, budgets mean everything and discipline means everything.

Which way is he going? We do not have any leadership, and you and I know that.

Secretary REGAN. No, no, I disagree entirely. I think the President is a fine leader.

Senator HOLLINGS. He is a fine leader but he is not exercising it.

Secretary REGAN. I think he is exercising it but the Congress is not following.

TUITION TAX CREDITS

Senator HOLLINGS. Which way does he want me to go? Does he really want tuition tax credits?

Secretary REGAN. Yes.

Senator HOLLINGS. You want to start another revenue hemorrhage?

Secretary REGAN. That is not a revenue hemorrhage. It is less than $50 million in the first year. The Senate wants more than that. Look at what the House did yesterday as far as failing to put a cap on Federal retirees' pensions.

Senator HOLLINGS. Medicare and medicaid started that way. We know where it is. We know from bitter hard experience when these programs start—it is a hemorrhage. You and I know it. You cannot start new programs involving Government in private affairs when you are trying to get the Government out of public affairs.

Secretary REGAN. I think in this particular case, the tuition tax credit bill, if that is the one you want to discuss, Senator, is something that the President talked about in the election campaign. It is the thing that the majority of people want. It gives the people an alternative to public education.

Senator HOLLINGS. We do not have to talk about that now. I have to yield because the chairman has been very indulgent.

Point 1, they did not talk about that in the campaign. It was in your platform. I ran in that campaign, and you look at the November 17, 1980, edition of U.S. News & World Report, and you see all the different lists of why people voted for the President. Right at the top was balance the budget, fiscal discipline. The so-called tax cut, incidentally, was less than 13 percent of Reagan voters. This is aggregate voters coming out of the polls. They were not talking that way in 1980. People do not want that. They have had that in

11 States, the opportunity to vote for it. Right here in the District of Columbia, in the wake of the White House, they vote it down 8 to 1. Every time the States have had—because the States have the primary responsibility for public education a chance to vote, the people vote it down. But that is just correcting a minor part of the record.

DISCIPLINE NEEDED

What I am talking about is the big picture. Nothing will happen between now and the election. We have to talk in terms of whether or not we are going to muddle on through or right after the election we might get the discipline, the discipline needed to save the country and to save the busted banks and bankruptcies and high unemployment and all of this suffering. I know you want to do that and I want to do it. We keep talking but we do not do it.

Secretary REGAN. Regarding the question of a lameduck session, I think that regardless of when it is done, the overriding consideration is that we must get some of the budget items under control. We are trying to pass the revenue bill now. Originally, you will recall, that all the measures indicated that there would be $3 of budget reductions for every $1 of revenue increase. I am afraid the way we are going, it will be one to one if we are not careful at this particular moment. That, I think, is wrong. I would sincerely hope that while in the process of passing this revenue bill, the Congress would come to grips with the cuts.

Senator HOLLINGS. Thank you.

Chairman DOMENICI. Senator Gorton?

Senator Gorton, will you chair for 5 or 10 minutes?

Senator GORTON [presiding]. Mr. Secretary, you referred in your formal remarks to the gratifying recent decrease in interest rates. Obviously, interest rates have not come down to a point at which you think they are satisfactory or consistently strong to sustain economic growth. Am I correct?

Secretary REGAN. That is correct, Senator.

Senator GORTON. So we have a great deal more to do. Do you think that even if the Congress should pass the President's tax bill and all of the cuts involved in reconciliation, leaving budget deficits perhaps somewhere between those in your midsession review or perhaps closer to those projected by CBO, that deficits of that nature are consistent with interest rates low enough to provide a real stimulus to sustained growth in the economy?

INTEREST RATES CAN KEEP COMING DOWN

Secretary REGAN. If all of the proposals of the first resolution are accomplished, both revenue increases and budget cuts, I think that interest rates can keep coming down, provided, of course, that monetary policy is sufficiently stable. I think there is no reason why rates would not continue to decline.

As I showed in one of those charts, the deficits are expected to fall to 2.1 percent of GNP by 1985. I think one can expect to see a continuing decline in interest rates as a result.

Senator GORTON. Does that imply that if all of this year's reconciliation is met, that we will not face a similar problem of decreas-

ing the growth rate of Federal spending, changing spending policies again next year?

Secretary REGAN. No. I think next year you will have to make certain that there are no further increases in the budget over and above what are being projected in the resolution for 1984. You are going to have to be vigilant on that.

Senator GORTON. But we will not have to make further changes in spending programs to cut back again on growth?

CAP THE COLAS

Secretary REGAN. I would want to examine that. I think there are some that are hitched to the rate of inflation, which would have to capped, as is called for in the concurrent resolution. If you do not cap them, they could increase budget outlays.

Senator GORTON. Could you now project, to the best of your ability, for me and for the committee the course of interest rates and economic recovery given two alternative scenarios? What do you think will happen with interest rates in the course of the next 6 months or 1 year if we in fact do, with great precision, abide by the terms of the first budget resolution through reconciliation and, alternatively, what would happen if the entire process failed, that is if the House refused to pass either significant spending reconciliation or the tax bill?

Senator BIDEN. In light of your past predictions, we would understand if you would not want to predict any more.

Secretary REGAN. I fail to follow what you mean by that.

Senator BIDEN. Your predictions have not been very accurate.

Secretary REGAN. Which one? Some of them have been very accurate.

Senator BIDEN. I should wait my turn. I apologize. I will bring them up at that point.

Secretary REGAN. Fine, if I can bring mine up at the same time.

It would be my judgment that if the concurrent resolution goes through, as was passed, and both the revenue increases and the budget cuts made, and if the monetary policy remains on a steady course of slow growth, I would say that interest rates would keep coming down. Where and to what, I do not know. But I would say that they would be below what they are now. In the event that this budget resolution fails, or the tax revenue bill is not passed, I think that the resulting deficits would frighten the marketplace. We would again have inflation and interest rates would stop coming down and turn around and go back up.

INTEREST RATES HAVE IMPACT ON INFLATION

Senator GORTON. Would that also have a direct impact on recovery?

Secretary REGAN. Certainly. Because even interest rates at 15 percent, we are not going to get much improvement in the economy. We need interest with rates in the 12-percent neighborhood before there could be much of a recovery.

Senator GORTON. Do you anticipate, under the same set of circumstances, a decline in mortgage interest rates as well as in the prime rate?

Secretary REGAN. Yes. Mortgage interest rates have started down. They have not come down as fast as the prime. But they have been coming down. I think they will continue down.

Senator GORTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Mr. Secretary, I happen to agree with you on the budget resolution and its implementation, and I do hope the President will be a little more vocal on both the tax bill and the budget cuts at the earliest possible time. I would not ask you for your view now, but it does appear to me that we need him out front very soon and very tough on the tax bill and on the budget cuts.

Secretary REGAN. Let me tell the chairman that the President is scheduled to meet this afternoon with the leaders of the conference as well as with the Republican leaders in both the House and the Senate. We will be meeting with others over the next few days in an effort to push this bill, particularly in the House, because many of the Members feel that they have not heard enough from the President. But the President certainly intends to get out there and to show his concern and the need for the passage of this bill.

Chairman DOMENICI. Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

Let me ask, Mr. Secretary, are you presently the chief economic spokesman for the administration?

Secretary REGAN. I am.

FORECAST NOT OFFICIAL

Senator RIEGLE. Do you support and endorse the administration's midyear forecast that Stockman brought in here yesterday?

Secretary REGAN. This is a forecast that we have agreed that we would use in the midsession review. It is not an official forecast of the administration. It merely updates the April 1 budget resolution. The reason we did that, Senator, after careful thought, was if we came up with a new set of projections we were afraid that the discussions would center around the figures themselves rather than the underlying problem. So, as a result, we decided just to update that forecast and to concentrate our attention on the budget process rather than the figures.

Senator RIEGLE. Do you support and endorse those numbers as being the most accurate assessment in your own mind?

Secretary REGAN. They are a fair assessment of what will happen, yes, growth in the 4 percent range.

Senator RIEGLE. You do endorse those numbers? You think they are accurate?

Secretary REGAN. I did not say accurate but I think they are in general—

Senator RIEGLE. They are not accurate? You are not were supporting inaccurate figures?

Secretary REGAN. They are an update of what the Congress saw in April and what we all agreed to at the time as being the most reasonable figures on which to base the first budget resolution.

NOBODY BELIEVES THE NUMBERS

Senator RIEGLE. Here is the problem we face and it is a problem that you face as the chief economic spokesman for the administration, and that is that you do have a reputation for honesty that goes back over a long period of time and through a very distinguished private career. The fact is that nobody believes these numbers, not even members of the President's own Cabinet. Secretary Baldridge yesterday in a sense disavowed the numbers, thought they were unrealistically low, he thought the deficit would be $20 billion higher. You are talking to the same people I am on Wall Street, your old associates, nobody puts any stock in those numbers, and yet you say, as you did in your statement, that you thought the old numbers based on the old data would be less confusing. That just does not wash because what, in effect, you are saying is less honest figures are less confusing and are better than honest figures.

I do not want you put in that position, and more importantly, I do not want the country put in that position. Can we not agree that we will put together an updated set of figures that are accurate? If we start from a false base, if we start a dishonest set of budget projections, and we go through this whole exercise, how is anybody going to gain from that? That is going to compound our problems.

I noticed on the date that the projections were made public, you were not commenting on that subject. You were, with typical Irish humor, commenting on other things, and when you were asked about it, you made a quip to the effect that you were smart enough to know what subjects to talk about on a given day, and you are smiling now because you know what I am saying is accurate. Why can we not be honest with each other? Would we not be doing the President a favor if we put honest numbers on the table and then started from that point?

Secretary REGAN. Senator, let us be realistic about these figures. No one knows for sure what will happen tomorrow, let alone next month or 6 weeks from now or 6 months from now, and we are trying to project what will happen 5 years from now.

Senator RIEGLE. Should we not have the best ones that we can get?

WHOSE NUMBERS ARE THE BEST

Secretary REGAN. Whose are the best? That is the point I was getting to. It has been my experience, with all due respect to economists, that their forecasts have a certain degree of validity at times and other times they are not worth the paper they are printed on. You could almost get the same results from flipping a coin.

Senator RIEGLE. Let me ask you differently—what is your forecast?

Secretary REGAN. It reminds me of an analogy where there are two doctors arguing over the temperature of a patient, whether it is 103.2 or 103.8. We know the patient is sick. We know what the problem is—

Senator RIEGLE. Wait a minute. Those are not the differences in the numbers. Let me give you the difference in the numbers.

OMB's deficit is 115 and CBO is 140. I can give you other private forecasters who say 140 to 150. For 1984, OMB is saying 92 billion and CBO is saying 145 to 160. And the same thing—it widens even further in 1985. These are not minor differences, Mr. Secretary. These are enormous differences. They are differences that approach $100 billion in the outyears.

I think we have to be honest with ourselves here. I think as the lead spokesman for the administration, I think you have the obligation to insist on integrity in these numbers.

Secretary REGAN. First of all, Senator, you realize that 60 percent of these comes from technical estimating differences between Treasury and CBO on revnues, and between OMB and CBO on outlays. The 60 percent has nothing to do with economic assumptions. Only 40 percent of the difference is from economic assumptions. The difference in 1983 is $8 billion, in economic assumptions. That is all. A major technical difference is in the CBO estimate of receipts. Now, if I can find the quote. Senator Hollings wrote to the CBO asking them to reprice the conference agreement on the first budget resolution and the results were published in the June 23 Congressional Record.

The CBO has "introduced a new, largely untested method of estimating revenues. It yields lower revenue estimates than the long-tested Treasury estimating method. The conferees—and the Senate—opted to use the Treasury figures based on their well-established methodology."

That, along with technical re-estimates of outlays, accounts for $99 billion of the $166 billion differences in deficits.

So what I am saying is it is not economic assumptions which most people think is the big difference between our figures and those of the CBO.

FIGURES ARE WITHIN A RANGE

Senator RIEGLE. But my question to you is, Is it your best professional estimate today carrying the responsibilities that you do, is it your best professional estimate that these budget projects that we received yesterday in the midyear report, are those the most accurate ones in your mind, are those the ones you believe?

Secretary REGAN. I think that the economy of this country will grow at a 4-percent rate——

Senator RIEGLE. I really think we ought to be able to get an answer——

Secretary REGAN. I am coming to it.

Chairman DOMENICI. He can answer it, Senator, in the way he sees fit.

Senator RIEGLE. I do not think the Chairman has to help him. He is capable of——

Chairman DOMENICI. He can answer as he sees fit. You cannot dictate to him or tell him how to answer.

Senator RIEGLE. I do not think I am.

Chairman DOMENICI. Yes, you are. You are badgering.

Secretary REGAN. I think the economy will grow at a 4-percent rate in the years 1983 through 1985. I think the inflation rate and the deflator will be around 6 to 6½ percent. In view of the esti-

mates, then the deficits that we project of $115 billion and the rest, are within a half of 1 percent of GNP of being correct. That means they could be down to $110 billion. They could be up to $125 billion, but they would be in that range. I do not think anyone could say it will be exactly $115 billion or $140 billion. That is too much precision for economic forecasts.

But I think in that range is entirely possible.

Senator RIEGLE. So when Secretary Baldridge comes in with a different view, as he did yesterday, as Secretary of Commerce, that means that his estimate is outside that range—does that mean he is probably wrong?

Secretary REGAN. I would put it this way, that as a manufacturer, he is entitled to have his economic forecasts. As a finance man, I will stick to mine.

Senator RIEGLE. You do not look like you feel badgered. I do not think you feel badgered.

Secretary REGAN. I will refrain from answering that one.

Senator RIEGLE. The Chairman is a little sensitive and I understand why.

Chairman DOMENICI. I did not hear that.

Senator RIEGLE. I think the Chairman is a little sensitive and I understand why.

Chairman DOMENICI. That is right, I am. But it is not at him; it is you.

Senator RIEGLE. I think it is the facts that you are troubled about.

Chairman DOMENICI. You talk about reducing budget deficits and you never vote for them. That is the problem.

Senator RIEGLE. Well, Mr. Chairman, I must just say, I offered several amendments last year to reduce some of the sacred cows in the budget, some of the water projects and defense spending and so forth, and there were many people, including yourself, who did not vote for those amendments. Let us not start indicting one another.

Chairman DOMENICI. You have a reputation for being fiscally responsible and reducing budgets regularly. There is no doubt about that.

Who is next?

Senator BIDEN. Did you have a good morning, Mr. Chairman?

Chairman DOMENICI. Super.

Senator BIDEN. I would not like to find you when you had a bad one. You used to be a nice calm guy. I remember when I was No. 100 and you were 99. We used to talk. You are getting mean.

Chairman DOMENICI. We did not talk. I was in the back seat on my side of the aisle and you were in the back seat on your side of the aisle. It is a long way to talk. Remember that?

Senator BIDEN. That is right. Now, I am in the back seat and you are in the front seat.

Let me tell you, I am not—by the way, in light of the electricity in the air this morning on this side of the aisle, Mr. Secretary, I was trying to be humorous with you. I was not being smart.

Secretary REGAN. It was a late night for all of us.

FORECASTING IS DIFFICULT

Senator BIDEN. I have heard you talk about the difficulty in forecasting and I was going to read to you what you said January 27, 1981 and July 12, 1981. You have been a little off.

Secretary REGAN. The Washington Post did that for you.

Senator BIDEN. I know. But, for the record, that is what I was referring to. But I would not go into that because, obviously, there is no place for humor this morning.

Chairman DOMENICI. Senator, I have to leave for about 10 minutes. You can be humorous.

Senator BIDEN. I must acknowledge that it will liven the situation. He has got a tough job, being Chairman of this Committee.

Let me ask you one serious question and then my colleagues who want to pursue you—we are in the process—as a matter of fact, in 1 hour and 56 minutes we are going to strike a vote for freedom on the floor of the U.S. Senate. We are going to vote on the constitutional amendment. If that amendment passes, and I think there is a better than even chance it will pass, I think the prospects—this is all—everyone has different forecasts. My forecast is if it passes, it will either become the law of the land within the next 6 to 8 months or it will never be. The States will either ratify it or will not. It will not hang around for long. I think there is an even chance that we could have a constitutional amendment on the books by the next legislative year. This time next year we could have a brandnew amendment enshrined in the Constitution that would take effect beginning with fiscal year 1985. We would be bound by it.

At that time, without arguing about whether the figures are 103 or 108, and I think the differences are 99 and 104. The administration is projecting a $73.6 billion budget. Let's say something over $50 billion, something under $100.

CBO is projecting budget deficits over $100 billion, something under $160 billion; a big real wide range—a lot of money.

Now, we will be bound to balance the budget that year. We will be bound to go in there and either raise revenues, $50 to $150 billion or cut spending $50 to $150 billion, or make a mockery of the whole process in the first year it is in place; announce to the American public we really did not mean it and by a super majority of 60 votes say we are going to vote for a budget being out of balance.

Now, I realize 1985 is relatively far off in terms of economic forecasts, but do you believe that in your second term—do you believe you could possibly—do you believe it is possible that you could submit to us in 1985 a balanced budget without doing jeopardy to economic growth, serious jeopardy, and this is a serious question.

BALANCED BUDGET IS POSSIBLE

Secretary REGAN. I understand, Senator. It is a tough one. There is no doubt that it is possible to have a balanced budget. Where the cuts would come or how the cuts would be accomplished would be a matter of priorities for the Congress and the then administration to come to grips with at that time.

As to how that would be done, what priorities would be established, that would be difficult to determine now. Would you say that domestic spending should go to nothing, and defense should remain where it is? That would depend on the international situation at that point and the state of readiness of the Armed Forces in relation to that situation. Defense might have to be cut. We would have to, of course, examine the rate of inflation at that time. If the rate of inflation is high, perhaps some type of cap such as we are trying to achieve this year, would be an example of what would have to be done in order to cut the budget. There is no doubt you would have to cut an additional $70 billion. But most forecasters estimate we are in the ball park of a $4 trillion economy; $75 or $80 billion would be 2 percent of GNP or less. I think that type of a reduction could be accomplished without seriously damaging the economic growth of the United States.

In terms of this year, with a $3 trillion economy, I think $60 billion can be cut. I think that is what we are trying to accomplish.

So, as far as a balanced budget in fiscal 1985 is concerned I think it is possible; probable, I do not know.

Senator BIDEN. I appreciate your answer and your candor, but we do agree that if that turns out to be the case, and your economic forecast and deficits are the most optimistic, on the low side, even with that, we are talking about fairly drastic action we would have to take here. Your sentence was not lost on me. You said domestic spending would either have to go to nothing, that is what we would have to do or we would have to take a big chunk out of defense or raise taxes significantly. You see how much trouble we are having with the tax bill this year.

Secretary REGAN. I just remind you, Senator, in that connection, indexing goes into effect that year and you would have to consider the effect of tax indexing on the problem at that point.

Senator BIDEN. You are an honorable man to point out how much more difficult it will be with that in place, and since I have no reason to keep talking, I will stop. I thank you.

Senator QUAYLE [presiding]. Senator Grassley?

Senator GRASSLEY. Part of your job is selling Treasury notes that cover the national debt. Now, yesterday, the House voted to restore full COLA's for Federal retirees. I use that as one example of what might be an inclination on the part of Congress to not stick by its budget resolution.

Is something like that going to have a negative impact upon today's 10-year Treasury note auction.

DIFFICULTIES IN RAISING FUNDS

Secretary REGAN. Yes; if, let us say, that by the time the Congress adjourns the first of October, sufficient outlay reductions are not in place, as I suggested in my answer to Senator Riegle, I think there will be difficulties in raising funds, not only because of cost but also because of availability. I think we are going to have real problems.

Senator GRASSLEY. And drive up interest on the national debt?

Secretary REGAN. Very definitely, Senator.

Senator GRASSLEY. Do you see the specific action the House took yesterday as having an immediate impact what is happening today in the sale of Treasury notes?

Secretary REGAN. No, I do not think it will have that much of an impact. One action by itself is not that significant, because it can be repaired. The Senate has voted the cap. There is a chance that the House action can be undone. But if there were no chance, and the Congress had indeed adjourned, then we would have problems.

Senator GRASSLEY. In yesterday's newspapers, there were suggestions that some disagreement exists within the administration—Mr. Stockman taking one position and you taking another position on the prospects of a tax increase for next year. How do you see that from your perspective today, as to whether or not there will be an administration effort to propose a tax increase for next year?

Secretary REGAN. I suppose whatever I say will be hauled out next year, so I had better be careful.

I think at this point, in view of conditions as I know them and understand them, I would not be in favor of tax increases next year, other than those that are built into the system by the revenue bill.

SERIOUS CONSIDERATION GIVEN TO FLAT TAX RATE

Senator GRASSLEY. How serious is the Administration's entertainment of the concept of a flat rate tax? I ask that as a followup to two statements out of the White House within the last month which suggested people within the administration, and specifically the President, were giving it serious consideration?

Secretary REGAN. The President is giving it serious consideration, as are others in this administration. It is an idea that has quite a bit of appeal and the longer I stay as Secretary of the Treasury and get into this loophole closing or loophole opening business and the ramifications for the Internal Revenue Code, the more I opt for a flat tax. But it is a concept that has to be studied carefully, Senator. It is easy to talk about but it is not an easy thing to accomplish and accomplish in an efficient way.

Example: I have used this before. Would you take a person earning $150,000 a year gross income at a 15 percent flat rate? The answer is why not? Would you do the same thing with a person with $15,000 of income, and the answer is no. If you say no to one and yes to others, that is not a flat rate. Immediately you are opting for a graduated tax.

In the past, I have headed a major fund raising effort for a university in which we raised $260 million. I wonder how much of that money in the future can be raised if there is no deduction for charities. I wonder what the effects on housing will be if there is no deduction for mortgage interest and under the flat tax rate there would be no such thing, no deductions. If you say, yes, we would have to have some exemptions, then you are not talking about a pure flat tax rate. It depends on what you mean by flat tax. I think it is something that deserves further explanation. I know there will be hearings in both houses of Congress on this, and I hope as the debate progresses we get a little more clarity on what people mean.

Senator GRASSLEY. The tax bill passed by the Senate, if approved by the House, contains a provision asking the Treasury to study a flat rate tax and come up with recommendations by the end of the year. Is that a reasonable period of time?

Secretary REGAN. Yes. Since we already have a study underway, we will be glad to come up with your findings by the end of the year.

Senator GRASSLEY. Do you think there is a possibility that the President might include such a recommendation in his 1984 budget?

Secretary REGAN. I would not want to venture a guess on that inasmuch as the President has not yet considered what his program will be for 1984.

MONEY GROWTH VOLATILITY

Senator GRASSLEY. I have a question on the Treasury study of money growth volatility and its effect on interest rates.

Could you discuss the findings of that study and tell us what you think the significance of it is?

Secretary REGAN. Well, we found in looking at money growth, that at least 2 percentage points of the current interest rate, that is 15 percent prime or the 13 percent long-term Government bond rate, are due to the volatility of the money supply. We tried to take out very carefully all of the other factors caused interest rates to be so high. There is no doubt, that volatility, particularly since 1979, has led to abnormal uncertainty in the money market and, as a result to, a larger risk premium than was the case in the decade prior to 1979.

Senator GRASSLEY. Have there been any actions taken by the Fed recently that would minimize the volatility and thereby give us some hope that those two points would come out of today's 15–16 percent interest rates?

CONTEMPORANEOUS RESERVE ACCOUNTING

Secretary REGAN. Yes. The Fed is doing a lot of studying. They are going to move to the contemporaneous reserve accounting system, CRA, sometime next year. They have also come up with a new method of trying to take some of the static out of the weekly figures, and they seem to have a much smoother path on their experimental model.

If that experimental model works, I think that in the years of 1983, 1984 and 1985 and on out, the money supply will be a lot smoother than it is currently. Something has to be done about it. They recognize the problems. I hope they eventually come to grips with it.

Senator GRASSLEY. I was not aware that they had moved to contemporaneous reserve accounting. I suggested they do that 2 or 3 years ago. They have made that decision?

Secretary REGAN. They have put that out as something they wish to adopt in 1983. They put it out for comment.

Senator GRASSLEY. But the decision has not been made?

Secretary REGAN. They decided they wanted to do it but they are asking what effect it will have on the banks if they do do it. Some of the banks are protesting that decision.

Senator GRASSLEY. Well, then, they could withdraw the decision.

Secretary REGAN. They could withdraw.

Senator GRASSLEY. Four or five years ago they tried to do it and then did not move forward on it.

Secretary REGAN. I think this time they are much more determined to do it and are going ahead with it.

Senator GRASSLEY. Thank you.

Senator QUAYLE. Mr. Secretary, not to get into a discussion of whose figures we want to believe on the deficit, I think it is fair to say that the deficits are simply too large and they have got to come down. Everybody in town is talking about that, both the executive branch and the legislative branch.

I just wonder, looking ahead to fiscal year 1984, that from the political point of view, Congress may have cut perhaps about as much as it is going to cut. We may get to some reforms on entitlements, but we still will likely come up rather significantly short as far as reducing the size of the deficit.

EXPANSION OF REVENUE BASE

Are we not going to have to again consider the expansion of the revenue base in this country? Your response to Senator Grassley is you are not in favor of tax increases. Nobody likes tax increases. No one has ever been thanked for increasing taxes or thanked for increasing someone else's taxes.

I wonder if you cannot get all those billions needed to reduce the deficit, won't Congress need to make a serious examination of the revenue base?

Secretary REGAN. No; I would not want to do that. I will tell you why. At the present, revenues as a percent of GNP are at about 20 percent and then, according to projections, fall back as GNP grows. If we start to take more than the current 19 to 20 percent of gross national product as revenue in the Federal tax system, and then add what States and local communities are taking, too much money will be taken from taxpayers. The incentives to save and invest will be destroyed. If we are going to have a $4 trillion economy, and if we are going to take just under 20 percent of that in taxes, we will have about $800 billion for the Federal Government to spend. I would think that would be enough. We should be able to keep outlays at about that level. We would refrain from spending rather than increasing taxes to meet spending.

Senator QUAYLE. Let me give you the situation that you cannot cut spending any further. Let us say that the Congress and the political institutions say that we no longer can make spending reductions and we are still $100 billion or $150 billion short. Then what? Just accept the deficit and go on?

Secretary REGAN. I would rather accept the deficit than increase taxes from the point of view of incentives, I will tell you that.

COMPARISON OF TAXATION

Senator QUAYLE. Do you think we are overtaxed or undertaxed? Is the amount of taxation that we pay as a Nation in comparison to others——

Secretary REGAN. We are below a lot of nations, particularly socialist countries. Now, a question here is whether we want to go down the path to a society in which the Government takes care of all services? If the government is going to take care of all services, obviously we are going to have to raise revenues. Philosophically, I am opposed to that. I would rather rely on the private sector and have less government and not more government.

Senator QUAYLE. What about some of the capitalist nations? What about Japan and Germany and the ones that have been rather productive in recent history? How about their tax base—are they undertaxed or overtaxed or——

Secretary REGAN. I think the Japanese pay less taxes than we do, and I think the Germans pay more taxes. Japan has a larger deficit. Germany's deficit is about in line with ours as a percentage of GDP.

Senator QUAYLE. If we were looking seriously at the so-called flat tax or simplified tax proposals—all of which have some element of progressivity—the political issue would be about how much progressivity. But in your discussions and your research on these tax simplification or flat tax proposals, can they provide a way to expand the revenue base? Do you anticipate getting more revenues, less revenues, or keep it about the same under the kind of proposal you might be coming forth with, at least the idea itself?

Secretary REGAN. We have not focused on the total amount of revenue. In the studies so far, we are looking at what type of flat or simplified tax brings in approximately the same revenue as we have currently. We leave it up to future administrations and Congresses to decide whether or not they want to raise more revenue or less.

I would say from our point of view, we would like to see less revenues being raised. I think personally that individuals can spend their money better than the Government. Coming from that philosophy, I do not see the need or the sense of Government continually raising revenues in order to spend continually.

RAISING REVENUES FROM CORPORATIONS

Senator QUAYLE. You talk about raising revenues from individuals. How about raising revenues from corporations? Has that not declined? It has gone down as far as a percentage of corporate tax from 16 percent to 6 or 7 percent in 1985. Are you separating the two? Are individuals paying more or are you lumping the two together?

Secretary REGAN. I am lumping those together. From the point of view of dollars, business taxes are rising. As a percentage of total tax collection, they have fallen.

Senator QUAYLE. Do you think they should continue to fall as a percentage of total tax collection?

Secretary REGAN. I think that the business taxes eat at the core of prosperity in this country. The more we tax, the less business we

will have. The less we tax business, I think the more stimulus we give to business to expand. The more expansion, the more jobs. It goes hand in glove. That is what we are trying to do. If we tax our businesses at a high level, they will not be able to finance a modern industry. You get an industry that is slowly decaying, that has no incentive to expand, to modernize, and the like. The net result is that businesses begin to deteriorate and end up being run by the Government.

Senator QUAYLE. Basically you are saying we need a reduction in taxes and also a reduction in revenues that we are generating from taxes. Am I correct?

Secretary REGAN. Yes, Senator.

Senator QUAYLE. Senator Chiles?

LONG-TERM INTEREST RATES

Senator CHILES. Mr. Secretary, all of us are delighted to see interest rates coming down and hope that they will come down further and, of course, most of the attention has been on the short-term rates. What do you see happening to the long-term rates and why have long-term rates stayed up as high as they have?

Secretary REGAN. Long-term Treasury issues were somewhere in the neighborhood of 14½ to 15 percent a couple of months ago. They are now down around 13, 13¼ at the current moment. They have come down somewhat. The reason they have not come down as fast is the fear of inflation. Most investors—I am talking here particularly of professional investors for insurance companies, pension funds, other large pools of money—are wondering what is going to happen to inflation 20 and 30 years out. They are not convinced as yet that the administration and the Congress have come to grips with the underlying problem. It is more of a show-me attitude. There has been some extension along the yield curves, but there is very little demand for 20- and 30-year money at this point.

Senator CHILES. Very little demand altogether, or very little demand at the high rate?

Secretary REGAN. Demand at that rate.

Senator CHILES. I think that is very true at the rate. There would be a tremendous demand if the rate was 12, 13 percent. As far as housing, there is a tremendous pent up demand, I think.

What do you see happening? Do you see this rate moving down? Here we are talking about real interest of 5 to 6 percent and that is something we have never seen for any period of time.

Secretary REGAN. I can see interest rates in the long term coming down provided several things happen. I hate to sound like a broken record and keep coming back to the same old theme. Nevertheless, the point is similar to what Senator Hollings was saying. We have to come to grips with the budgets of the future and whether or not we are actually going to get Federal spending under control. If the marketplace is convinced that we are serious, and if they are convinced that the administration is not going to come in with an easy-money policy and tell the Fed to pump up the money supply for some political or other advantage—a quick fix in other words—I think the marketplace will start to recognize that they can afford to go out into the long area.

Also, as I was saying to Senator Grassley, the volatility premiums, represent at least 2 percentage points that could easily be eliminated if markets were more certain about what money growth rates were. Accordingly, you can see interest rates coming down 2 or 3 percentage points over the next year or so as money growth is stabilized.

CAPITAL INVESTMENT DOWN

Senator CHILES. How do you explain the fact that capital investment has gone down and appears to be still down after we have passed this tremendous tax decrease, given the incentives that we have given to business, and given the plan that all of this was going to build capital formation in this country?

Secretary REGAN. Well, in an effort to keep the answer brief, I will oversimplify it.

The recession is largely responsible for creating unused capacity in plants. Our manufacturing establishments are now operating at less than 70 percent of capacity. Why would a company expand when it has that idle capacity? If capacity utilization gets back up into the 80- to 85-percent area, then management will start to expand capacity. But there is no need to do so at the current moment. This is an unfortunate result of the recession. But I do not think I could fault management for doing what it is supposed to do, which is to look out for the welfare of the company. The welfare of the company dictates that with idle capacity, there should be no expansion.

Senator CHILES. Does that tell us something, that the healthy or unhealthy state of the economy has more to do with whether there is going to be expansion or not, than us feeling like we are giving them a bunch of tax breaks? In cutting our revenues, did that have something to do with what happened to the economy?

Secretary REGAN. There were tax incentives given if you were to take a certain course of action. Since the course of action is not taken, there is no tax impact.

SAFE HARBOR LEASING

Senator CHILES. Part of them were. Safe Harbor Leasing, you know, used some dollars regardless.

Secretary REGAN. True.

Senator CHILES. Did not start any new things. Part of the across-the-board taxes certainly used dollars and did not require that they have to do something. Some of the additional depreciation went into effect on the basis of what was already there, already planned.

Secretary REGAN. As far as the Safe Harbor Leasing is concerned, I think it is easy to defend—not some of the excesses—but at least the theory behind it. Many of the industries that were ailing in the United States certainly got a boost out of it. The airline industry is one. I think they tell a very convincing story in that they are able to buy and contract for new planes, because the investment tax credit and Safe Harbor Leasing made it possible for them to do so.

Senator QUAYLE. Senator Johnston?

Senator JOHNSTON. Mr. Secretary, last year I asked you and I also asked Mr. Volcker the same questions. That is, first, are the administration and the Fed in contact on interest rates, and the answer was, "Yes, that has been a long tradition"; and, second, I asked whether the Fed's policy was essentially the administration's policy and vice versa, and the answer was, "Yes, it is, that the two are very parallel."

I want to ask you the two same questions today. Is the Fed's policy the administration's policy?

Secretary REGAN. And the answer is still yes, Senator.

LOWERING INTEREST RATES MECHANICALLY

Senator JOHNSTON. Is it not possible, from a mechanical standpoint, I do not ask for a value judgment as to whether it should be done, but is it not possible from a mechanical standpoint for the Fed to lower interest rates at least clearly in the short term and, if so, how would you do that mechanically?

Secretary REGAN. I think that the way the Fed is doing it is the right way to do it, and that is by gradually reducing the discount rates, by gradually using other tools that they have at their disposal that can indicate that they are easing money.

Senator JOHNSTON. I ask not for a value judgment of whether or not they are doing it right or not. Is it possible for the Fed to do it and to achieve within reasonable limits almost any interest rate they want?

Secretary REGAN. Not with such precision. But in general, yes. They can bring rates down or push them up. However, if they bring interest rates down too quickly by pumping too much money into the system they can get a reverse effect. Such a policy scares the market and interest rates go up. We have noticed this happen several times recently when money growth was too fast.

An example is January of this year. Money supply growth was at a 20-percent annual rate for that 1 month and interest rates shot up. When the Fed cut back on money growth, interest rates started to subside. Too much money had been pumped in, in January. That is why I used the word gradual. If the Fed put money into the marketplace gradually, on keeping the money supply in the 5½- to 6-percent range, they can bring interest rates down.

Senator JOHNSTON. The Fed can send traders into the market and intervene in the purchase of securities and keep the market down.

Secretary REGAN. Sure, on open market purchases certainly.

Senator JOHNSTON. So that effectually, again without regard to whether they could or should, they certainly can bring interest rates down and bring them down rather rapidly.

Secretary REGAN. Not rather rapidly but they can bring them down.

Senator JOHNSTON. The reason not to bring interest rates down is because of the danger of reigniting inflation, is that not correct?

Secretary REGAN. Yes.

FEAR OF REIGNITING INFLATION

Senator JOHNSTON. Now, when you have factory utilization at less than 70 percent, is there really a fear of reigniting inflation? What I am saying is should we not go back to the traditional way that the Fed controlled—operated with respect to the money supply which was using interest rates as targets, real interest rates as targets rather than some fictitious money supply measure which I do not think is all that precise anyway, because you keep redefining different modes of money that move in and out— M_{1B} or M_2 or whatever?

Secretary REGAN. No, Senator, I would not quite agree with that. I think when they concentrated on interest rates, they overlooked money supply. In an effort to keep interest rates down, they found that they were pumping too much money in to the ecocomy, and this triggered the inflationary fears of the marketplace. I think they have to keep their eye first on the money supply and second on interest rates, but they should be conscious of interest rates and interest rate levels.

Senator JOHNSTON. I do not see how the money supply is a valid enough measure. This past year, the Fed virtually hit its target on M_2 but was way below on its target of M_{1B} which indicates they did not understand the interplay between M_{1B} and M_2, or else these are not precise enough measures to use as targets.

Is that not right?

Secretary REGAN. There are many of the monetarist persuasion, including Milton Friedman, who think the Federal Reserve should be looking at the base rather than at M_1 or M_2 because the Fed has more control over the base.

POST-SEASON SESSION

Senator JOHNSTON. Mr. Secretary, will we have a post-election session to deal with social security?

Secretary REGAN. I cannot answer that with any precision now. I would hope that something would be done in the post-session rather than wait for the budget process in the early months of 1983. As Chairman of the Trustees, I recognize that our funds needs replenishing rather quickly in 1983, and the sooner that this Congress comes to grips with how to replenish those funds, the better.

Senator JOHNSTON. If I may, I want to make one further comment, and that is to thank the Secretary and to urge him to continue to work on Puerto Rico's section 936 problem. I think it is a measure of first order of priority. I think we threaten to destabilize Puerto Rico with the provision in the Senate passed bill, and I know you have been working to get a compromise so it can work. But things down there are very, very serious.

Secretary REGAN. I agree with the Senator on that. And we are, as I said before, meeting with the President today and the conference chairmen. This will be one of many things I hope that is again brought to their attention. With 23 percent unemployment in the island and the low average per capita income, I think that we certainly should not be pulling the rug out from under them.

Senator JOHNSTON. Thank you.

Senator QUAYLE. Thank you.

I am afraid you have a Cabinet meeting with the President at 11. It is now 20 minutes to.

Senator Symms just came in. He has a Cabinet meeting. Senator Riegle promised to be short. Why do we not let Senator Riegle have 1 minute.

Secretary REGAN. If I can leave here at 10 of 11.

Senator RIEGLE. Mr. Secretary, all of the evidence I see and people who are coming to me and speaking to me from major companies and major economic and financial institutions across the country, many of the same people to whom you are speaking to, say they feel that our economy is in very deep trouble and in fact that the world economy is in very deep trouble. You nod in the affirmative. I gather you are hearing the same things from those people.

Secretary REGAN. Yes, I am.

Senator RIEGLE. We look out across the country and we see 10.5 million people unemployed, which is the highest number of people out of work since 1938, the depression in the housing industry, and 550 bankruptcies a week. We are losing one every 20 minutes around the clock, 7 days a week, and we are having, just not in my State of Michigan, but increasingly across the country, desperate human conditions where people have exhausted unemployment, insurance, they are losing their homes, losing their cars, and the situation is really becoming quite extreme.

CONSISTENCY LACKING

Looking at the economic policy of the administration, we see a lot of people leaving. Murray Weidenbaum is leaving. Craig Robert, and Martin Anderson just left. Mr. Curry just left. There are others that I might name. There is a growing feeling in the people I talk to that there is not a workable plan in place, and there is not the kind of internal consistency there needs to be.

Let me cite two or three of the inconsistencies. And many people say, including many of your best supporters, that the administration wants a balanced budget but it does not submit one and has not submitted one as far out as the eye can see. Businesses need consistent tax rules. We cut taxes last year to try to help on the supply side. I voted for that bill on final passage despite some reservations. This year, the administration is back raising taxes and business is squawking about that, saying there is a direct inconsistency. You have people like Jack Kemp and Bill Buckley and others that have jumped and are fighting tooth and nail. The President says he wants budget restraint but, this week, he said the lid is off on defense spending. That has caused great upset on both sides of the aisle. The administration sends up budget projections that, frankly nobody believes. And now you yourself have expressed skepticism about that. You criticized the Fed policy over the last few months. Today you say you support them. You are apparently doing a study about changing Fed policy. There is a contradiction there.

The President now wants a constitutional amendment to balance the budget. Early this spring you said it would be counterproductive and you have expressed some reservations today about that.

Deficits are out of control. All of these contradictions are making the problem worse.

MIDCOURSE CORRECTION NEEDED

Now, many of us think we need a major midcourse correction in the economy. I just want to make an urgent appeal to you, and I do so not just from the perspective of how severe the conditions are in Michigan, but I think you need to deal with these contradictions and resolve them. Especially because you have been designated as the lead economic player in the administration, because these contradictions, and I could cite others, are paralyzing the economy. They are paralyzing the economy for any kind of strong economic recovery. Almost every professional thinks that is what is holding the interest rates as high as they are. Unless somebody that has the kind of forcefulness you have and takes the lead and resolves the contradictions that are on the table, we are not going to get out of this quagmire and things are apt to get worse and not lead to a strong recovery.

I would like to appeal to you to do that because you are perhaps the only person in the administration that is in a position to give us the leadership.

Secretary REGAN. Thank you very much for the very kind words. Let me tick off some of those seemingly contradictory things you mentioned because I think there are answers to each of them and I will try to make this brief, Mr. Chairman.

As far as people leaving, I think that most of those people were under constraints to get back to their academic careers. Murray Weidenbaum and Craig Roberts are examples. Norman Ture was one of my right-hand men at Treasury. Frankly, he was having financial pressures. He came in and served his time. I knew he would be leaving 15 or 18 months after he came in. He did his duty and he has left with our approval.

As far as others leaving, I think it is much the same. There is not any confusion as far as our policies are concerned.

Now, regarding the question of not having submitted a balanced budget, the President has submitted a budget with an understanding that we would try for the balanced budget as quickly as we could. In working with the Gang of 17, it became apparent that there was no way to get a balanced budget through Congress quickly.

So the budgets we have submitted are tentative budgets. They can be addressed and can be brought into balance only through some hard work and tough decisions.

I think, again as Senator Hollings suggested, sooner or later the Congress and the administration are going to have to come to grips with this issue. But whether or not we can do it in this preelection atmosphere, I do not know.

As far as the tax rules and what business is saying about taxes, let me point out something. What we achieved last year was the largest single tax reduction in the history of business. We have

changed very little of the underlying portion of that. The business taxes that we are raising this year are mainly targeted at certain specific industries, for example, the insurance industry, general contractors, things of that nature. This is not a flat across-the-board reduction of what we passed last year. In the case of safe harbor leasing, everyone agreed that there were probably excesses.

Senator QUAYLE. Senator, he has got to leave in 5 minutes and Senator Symms has not had one round of questioning.

Secretary REGAN. Regarding the constitutional amendment, let me make clear that I am definitely in favor of it. What I may seem to be wavering on is not the constitutional amendment but the flat tax. That needs to be studied. I would not want the two to be confused. I am definitely in favor of the constitutional amendment.

Senator QUAYLE. Senator Symms?

Senator SYMMS. I will be very brief and not ask you any questions. I understand you have to be at the White House in 15 minutes.

TAX RECONCILIATION PACKAGE IS TWO-WAY STREET

I would encourage you, in the high councils of the administration, to try to encourage the President to make it very clear with the other body, the House, that this tax reconciliation package is a two-way street. From what I hear in the last 48 hours, it appears there seems to be a breakup as far as the spending side of this whole equation is concerned and I am certainly going to encourage Senator Dole this morning to make it clear with the House if they think that the Senate is going to raise taxes and take all the blame or credit, however it goes, to raise revenues just so the big spenders can have more money to spend, that will not work out their way because it still has not passed in the Senate. And a lot of us are backing the whole reconciliation package as a package, considering that we will get all those spending cuts that the reconciliation package calls for.

I hope the President—with his great abilities in communication with the Members of the House—can communicate that to the House, that this is a two-way street; that I can see the seeds being sown already in the House, erosion from the spending side of this budget reconciliation package and it will not work. If they are not willing to bite the bullet and cut the spending, it will probably end up they will not have the additional revenues from the Tax Equity Act that was passed here in the Senate last week.

I hope you will share that point of view also.

Secretary REGAN. All I can say to that is amen. I definitely understand what the Senator is saying. It is something that the President is well aware of, as are others of us on Pennsylvania Avenue. We will be discussing the necessity for getting spending cuts in line with revenue increases with the conferees when the President meets with them today. We have to have both.

Senator QUAYLE. Thank you.

Secretary REGAN. Thank you, gentlemen. I appreciate the courtesies.

[Whereupon, at 10:48 a.m., the committee adjourned, subject to the call of the Chair.].

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 20, 1982

I am pleased to have this opportunity once again to discuss monetary policy with you within the context of recent and prospective economic developments. As usual on these occasions, you have the Board of Governors' "Humphrey-Hawkins" Report before you. This morning I want to enlarge upon some aspects of that Report and amplify as fully as I can my thinking with respect to the period ahead.

In assessing the current economic situation, I believe the comments I made five months ago remain relevant. Without repeating that analysis in detail, I would emphasize that we stand at an important crossroads for the economy and economic policy.

In these past two years we have traveled a considerable way toward reversing the inflationary trend of the previous decade or more. I would recall to you that, by the late 1970s, that trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy. Dealing with inflation was accepted as a top national priority, and, as events developed, that task fell almost entirely to monetary policy.

In the best of circumstances, changing entrenched patterns of inflationary behavior and expectations -- in financial markets, in the practices of business and financial institutions, and in labor negotiations -- is a difficult and potentially painful process. Those, consciously or not, who had come to "bet" on rising prices and the ready availability of relatively cheap

98-044 O - 82 -- 12

credit to mask the risks of rising costs, poor productivity, aggressive lending, or over-extended financial positions have found themselves in a particularly difficult position.

The pressures on financial markets and interest rates have been aggravated by concerns over prospective huge volumes of Treasury financing, and by the need of some businesses to borrow at a time of a severe squeeze on profits. Lags in the adjustment of nominal wages and other costs to the prospects for sharply reduced inflation are perhaps inevitable, but have the effect of prolonging the pressure on profits -- and indirectly on financial markets and employment. Remaining doubts and skepticism that public policy will "carry through" on the effort to restore stability also affect interest rates, perhaps most particularly in the longer-term markets.

In fact, the evidence now seems to me strong that the inflationary tide has turned in a fundamental way. In stating that, I do not rely entirely on the exceptionally favorable consumer and producer price data thus far this year, when the recorded rates of price increase (at annual rates) declined to 3½ and 2⅓%, respectively. That apparent improvement was magnified by some factors likely to prove temporary, including, of course, the intensity of the recession; those price indices are likely to appear somewhat less favorable in the second half of the year. What seems to me more important for the longer run is that the trend of underlying costs and nominal wages has begun to move lower, and that trend should be sustainable as the

economy recovers upward momentum. While less easy to identify -- labor productivity typically does poorly during periods of business decline -- there are encouraging signs that both management and workers are giving more intense attention to the effort to improve productivity. That effort should "pay off" in a period of business expansion, helping to hold down costs and encouraging a revival of profits, setting the stage for the sustained growth in real income we want.

I am acutely aware that these gains against inflation have been achieved in a context of serious recession. Millions of workers are unemployed, many businesses are hardpressed to maintain profitability, and business bankruptcies are at a postwar high. While it is true that some of the hardship can reasonably be traced to mistakes in management or personal judgment, including presumptions that inflation would continue, large areas of the country and sectors of the economy have been swept up in more generalized difficulty. Our financial system has great strength and resiliency, but particular points of strain have been evident.

Quite obviously, a successful program to deal with inflation, with productivity, and with the other economic and social problems we face cannot be built on a crumbling foundation of continuing recession. As you know, there have been some indications -- most broadly reflected in the rough stability of the real GNP in the second quarter and small increases in the leading indicators -- that the downward adjustments may be drawing

to a close. The tax reduction effective July 1, higher social security payments, rising defense spending and orders, and the reductions in inventory already achieved, all tend to support the generally held view among economists that some recovery is likely in the second half of the year.

I am also conscious of the fact that the leveling off of the GNP has masked continuing weakness in important sectors of the economy. In its early stages, the prospective recovery must be led largely by consumer spending. But to be sustained over time, and to support continuing growth in productivity and living standards, more investment will be necessary. At present, as you know, business investment is moving lower. House building has remained at depressed levels; despite some small gains in starts during the spring, the cyclical strength "normal" in that industry in the early stages of recovery is lacking. Exports have been adversely affected by the relative strength of the dollar in exchange markets.

I must also emphasize that the current problems of the American economy have strong parallels abroad. Governments around the world have faced, in greater or lesser degree, both inflationary and fiscal problems. As they have come to grips with those problems, growth has been slow or non-existent, and the recessionary tendencies in various countries have fed back, one on another.

In sum, we are in a situation that obviously warrants concern, but also has great opportunities. Those opportunities lie in major part in achieving lasting progress -- in pinning

down and extending what has already been achieved -- toward price stability. In doing so, we will be laying the base for sustaining recovery over many years ahead, and for much lower interest rates, even as the economy grows. Conversely, to fail in that task now, when so much headway has been made, could only greatly complicate the problems of the economy over time. I find it difficult to suggest when and how a credible attack could be renewed on inflation should we neglect completing the job now. Certainly the doubts and skepticism about our capacity to deal with inflation -- which now seem to be yielding -- would be amplified, with unfortunate consequences for financial markets and ultimately for the economy.

I am certain that many of the questions, concerns and dangers in your mind lie in the short run -- and that those in good part revolve around the pressures in financial markets. Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there, in fact, enough liquidity in the economy to support expansion -- but not so much that inflation is reignited? Will, in fact, the economy follow the recovery path so widely forecast in coming months?

These are the questions that we in the Federal Reserve must deal with in setting monetary policy. As we approach these policy decisions, we are particularly conscious of the fact that monetary policy, however important, is only one instrument of economic policy. Success in reaching our common objective of a strong and prosperous economy depends upon more

than appropriate monetary policies, and I will touch this morning on what seem to me appropriately complementary policies in the public and private sectors.

The Monetary Targets

Five months ago, in presenting our monetary and credit targets for 1982, I noted some unusual factors could be at work tending to increase the desire of individuals and businesses to hold assets in the relatively liquid forms encompassed in the various definitions of money. Partly for that reason -- and recognizing that the conventional base for the M1 target of the fourth quarter of 1981 was relatively low -- I indicated that the Federal Open Market Committee contemplated growth toward the upper ends of the specified ranges. Given the "bulge" early in the year in M1, the Committee also contemplated that that particular measure of money might for some months remain above a "straight line" projection of the targeted range from the fourth quarter of 1981 to the fourth quarter of 1982.

As events developed, M1 and M2 both remained somewhat above straight line paths until very recently. M3 and bank credit have remained generally within the indicated range, although close to the upper ends. (See Table I.) Taking the latest full month of June, M1 grew 5.6% from the base period and M2 9.4%, close to the top of the ranges. To the second quarter as a whole, the growth was higher, at 6.8% and 9.7%, respectively. Looked at on a year-over-year basis, which appropriately tends to average through volatile monthly and quarterly figures, M1 during the first half of 1982 averaged about 4-3/4% above the

first half of 1981 (after accounting for NOW account shifts early last year). On the same basis, M2 and M3 grew by 9.7 and 10.5 percent, respectively, a rate of growth distinctly faster than the nominal GNP over the same interval.

In conducting policy during this period, the Committee was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation. One reflection of that may be found in unusually large declines in "velocity" over the period -- that is, the ratio of measures of money to the gross national product. M1 velocity -- particularly for periods as short as three to six months -- is historically volatile. A cyclical tendency to slow (relative to its upward trend) during recessions is common. But an actual decline for two consecutive quarters, as happened late in 1981 and the first quarter of 1982, is rather unusual. The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period. Moreover, declines in velocity of this magnitude and duration are often accompanied by (and are related to) reduced short-term interest rates. Those interest rate levels during the first half of 1982 were distinctly lower than during much of 1980 and 1981, but they rose above the levels reached in the closing months of last year.

More direct evidence of the desire for liquidity or precautionary balances affecting M1 can be found in the behavior of NOW accounts. As you know, NOW accounts are a relatively

new instrument, and we have no experience of behavior over the course of a full business cycle. We do know that NOW accounts are essentially confined to individuals, their turnover relative to demand accounts is relatively low, and, from the standpoint of the owner, they have some of the characteristics of savings deposits, including a similarly low interest rate but easy access on demand. We also know the great bulk of the increase in M1 during the early part of the year -- almost 90% of the rise from the fourth quarter of 1981 to the second quarter of 1982 -- was concentrated in NOW accounts, even though only about a fifth of total M1 is held in that form. In contrast to the steep downward trend in low-interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions.

I would add that the financial and liquidity positions of the household sector of the economy, as measured by conventional liquid asset and debt ratios, has improved during the recession period. Relative to income, debt repayment burdens have declined to the lowest level since 1976. Trends among business firms are clearly mixed. While many individual firms are under strong pressure, some rise in liquid asset holdings for the corporate sector as a whole appears to be developing. The gap between internal cash flow (that is, retained earnings and depreciation allowances) and spending for plant, equipment, and inventory

has also been at an historically low level, suggesting that a portion of recent business credit demands is designed to bolster liquidity. But, for many years, business liquidity ratios have tended to decline, and balance sheet ratios have reflected more dependence on short-term debt. In that perspective, any recent gains in liquidity appear small.

In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions -- and presumably more pressures on the money markets and interest rates in the short run. At the same time, an unrestrained build-up of money and liquidity clearly would have been inconsistent with the effort to sustain progress against inflation, both because liquidity demands could shift quickly and because our policy intentions could easily have been misconstrued. Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries. Indeed, velocity appears to have risen slightly during the second quarter, and the growth in NOW accounts has slowed.

Judgments on these seemingly technical considerations inevitably take on considerable importance in the target-setting process because the economic and financial consequences (including

the consequences for interest rates) of a particular M1 or M2 increase are dependent on the demand for money. Over longer periods, a certain stability in velocity trends can be observed, but there is a noticeable cyclical pattern. Taking account of those normal historical relationships, the various targets established at the beginning of the year were calculated to be consistent with economic recovery in a context of declining inflation. That remains our judgment today. Inflation has, in fact, receded more rapidly than anticipated at the start of the year potentially leaving more "room" for real growth. On that basis, the targets established early in the year still appeared broadly appropriate, and the Federal Open Market Committee decided at its recent meeting not to change them at this time.

However, the Committee also felt, in the light of developments during the first half, that growth around the top of those ranges would be fully acceptable. Moreover -- and I would emphasize this -- growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money. We will look to a variety of factors in reaching that judgment, including such technical factors as the behavior of different components in the money supply, the growth of credit, the behavior of banking and financial markets, and more broadly, the behavior of velocity and interest rates.

I believe it is timely for me to add that, in these circumstances, the Federal Reserve should not be expected to respond, and does not plan to respond, strongly to various "bulges" -- or for that matter "valleys" -- in monetary growth that seem likely to be temporary. As we have emphasized in the past, the data are subject to a good deal of statistical "noise" in any circumstances, and at times when demands for money and liquidity may be exceptionally volatile, more than usual caution is necessary in responding to "blips."*

We, of course, have a concrete instance at hand of a relatively large (and widely anticipated) jump in M1 in the first week of July -- possibly influenced to some degree by larger social security payments just before a long weekend. Following as it did a succession of money supply declines, that increase brought the most recent level for M1 barely above the June average, and it is not of concern to us.

It is in this context, and in view of recent declines in short-term market interest rates, that the Federal Reserve yesterday reduced the basic discount rate from 12 to 11½ percent.

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*In that connection, a number of observers have noted that the first month of a calendar quarter -- most noticeably in January and April -- sometimes shows an extraordinarily large increase in M1 -- amplified by the common practice of multiplying the actual change by 12 to show an annual rate. Those bulges, more typically than not, are partially "washed out" by slower than normal growth the following month. The standard seasonal adjustment techniques we use to smooth out monthly money supply variations -- indeed, any standard techniques -- may, in fact, be incapable of keeping up with rapidly changing patterns of financial behavior, as they affect seasonal patterns. A note attached to this statement sets forth some work in process developing new seasonal adjustment techniques.

In looking ahead to 1983, the Open Market Committee agreed that a decision at this time would -- even more obviously than usual -- need to be reviewed at the start of the year in the light of all the evidence as to the behavior of velocity, or money and liquidity demand, during the current year. Apart from the cyclical influences now at work, the possibility will need to be evaluated of a more lasting change in the trend of velocity.

The persistent rise in velocity during the past twenty years has been accompanied by rising inflation and interest rates -- both factors that encourage economization of cash balances. In addition, technological change in banking -- spurred in considerable part by the availability of computers -- has made it technically feasible to do more and more business on a proportionately smaller "cash" base. With incentives strong to minimize holdings of cash balances that bear no or low interest rates, and given the technical feasibility to do so, turnover of demand deposits has reached an annual rate of more than 300, quadruple the rate ten years ago. Technological change is continuing, and changes in regulation and bank practices are likely to permit still more economization of M1-type balances. However, lower rates of interest and inflation should moderate incentives to exploit that technology fully. In those conditions, velocity growth could slow, or conceivably at some point stop.

To conclude that the trend has in fact changed would clearly be premature, but it is a matter we will want to evaluate carefully as time passes. For now, the Committee felt that the

existing targets should be tentatively retained for next year. Since we expect to be around the top end of the ranges this year, those tentative targets would of course be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal cyclical rise in velocity. With inflation declining, the tentative targets would appear consistent with, and should support, continuing recovery at a moderate pace.

The Blend of Monetary and Fiscal Policy

The Congress, in adopting a budget resolution contemplating cuts in expenditures and some new revenues, also called upon the Federal Reserve to "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." I can report that members of the Committee welcomed the determination of the Congress to achieve greater fiscal restraint, and I want particularly to recognize the leadership of members of the Budget Committees and others in achieving that result. In most difficult circumstances, progress is being made toward reducing the huge potential gap between receipts and expenditures. But I would be less than candid if I did not also report a strong sense that considerably more remains to be done to bring the deficit under control as the economy expands. The fiscal situation as we appraise it, continues to carry the implicit threat of "crowding out" business investment and housing as

the economy grows -- a process that would involve interest rates substantially higher than would otherwise be the case. For the more immediate future, we recognized that the need remains to convert the intentions expressed in the Budget Resolution into concrete legislative action.

In commenting on the budget, I would distinguish sharply between the "cyclical" and "structural" deficit -- that is, the portion of the deficit reflecting an imbalance between receipts and expenditures even in a satisfactorily growing economy with declining inflation. To the extent the deficit turns out to be larger than contemplated entirely because of a shortfall in economic growth, that "add on" would not be a source of so much concern. But the hard fact remains that, if the objectives of the Budget Resolution are fully reached, the deficit would be about as large in fiscal 1983 as this year even as the economy expands at a rate of 4 to 5 percent a year and inflation (and thus inflation generated revenues) remains higher than members of the Open Market Committee now expect.

In considering the question posed by the Budget Resolution, the Open Market Committee felt that full success in the budgetary effort should itself be a factor contributing to lower interest rates and reduced strains in financial markets. It would thus

assist importantly in the common effort to reduce inflationary pressures in the context of a growing economy. By relieving concern about future financing volume and inflationary expectations, I believe as a practical matter a credibly firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears. Specifically, market anxiety that short-run increases in the Ms might presage continuing monetization of the debt could be ameliorated. But any gains in these respects will of course be dependent on firmness in implementing the intentions set forth in the Resolution and on encouraging confidence among borrowers and investors that the effort will be sustained and reinforced in coming years.

Taking account of all these considerations, the Committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth -- and perceptions thereof -- would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

Concluding Comments

In an ideal world, less exclusive reliance on monetary policy to deal with inflation would no doubt have eased the strains and high interest rates that plague the economy and financial markets today. To the extent the fiscal process can now be brought more fully to bear on the problem, the better off we will be -- the more assurance we will have that interest rates will decline and keep declining during the period of recovery, and that we will be able to support the increases in investment and housing essential to healthy, sustained recovery. Efforts in the private sector -- to increase productivity, to reduce costs, and to avoid inflationary and job-threatening wage increases -- are also vital, even though the connection between the actions of individual firms and workers and the performance of the economy may not always be self-evident to the decision makers. We know progress is being made in these areas, and more progress will hasten full and strong expansion.

But we also know that we do not live in an ideal world. There is strong resistance to changing patterns of behavior and expectations ingrained over years of inflation. The slower the progress on the budget, the more industry and labor build in cost increases in anticipation of inflation or Government acts to protect markets or impede competition, the more highly speculative financing is undertaken, the greater the threat that available supplies of money and credit will be exhausted in financing rising prices instead of new jobs and growth. Those in vulnerable competitive positions are most likely to feel the

impact first and hardest, but unfortunately the difficulties spread over the economic landscape.

The hard fact remains that we cannot escape those dilemmas by a decision to give up the fight on inflation -- by declaring the battle won before it is. Such an approach would be transparently clear -- not just to you and me -- but to the investors, the businessmen and the workers who would, once again, find their suspicions confirmed that they had better prepare to live with inflation, and try to keep ahead of it. The reactions in financial markets and other sectors of the economy would, in the end, aggravate our problems, not eliminate them. It would strike me as the cruelest blow of all to the millions who have felt the pain of recession directly to suggest, in effect, it was all in vain.

I recognize months of recession and high interest rates have contributed to a sense of uncertainty. Businesses have postponed investment plans. Financial pressures have exposed lax practices and stretched balance sheet positions in some institutions -- financial as well as non-financial. The earnings position of the thrift industry remains poor.

But none of those problems can be dealt with successfully by re-inflation or by a lack of individual discipline. It is precisely that environment that contributed so much to the current difficulties.

In contrast, we are now seeing new attitudes of cost containment and productivity growth -- and ultimately our industry will be in a more robust competitive position. Millions are

98-044 O - 82 -- 13

benefitting from less rapid price increases -- or actually lower prices -- at their shopping centers and elsewhere. Consumer spending appears to be moving ahead, and inventory reductions help set the stage for production increases.

Those are developments that should help recovery get firmly underway. The process of disinflation has enough momentum to be sustained during the early stages of recovery -- and that success can breed further success as concerns about inflation recede. As recovery starts, the cash flow of business should improve. And, more confidence should encourage greater willingness among investors to purchase longer debt maturities. Those factors should, in turn, work toward reducing interest rates, and sustaining them at lower levels, encouraging in turn the revival of investment and housing we want.

I have indicated the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty. Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures. The recent problems related largely to the speculative activities of a few highly leveraged firms can and will be contained, and over time, an appropriate sense of prudence in taking risks will serve us well.

We have been through -- we are in -- a trying period. But too much has been accomplished not to move ahead and complete the job of laying the groundwork for a much stronger economy. As we look forward, not just to the next few months but to long

years, the rewards will be great: in renewed stability, in growth, and in higher employment and standards of living. That vision will not be accomplished by monetary policy alone. But we mean to do our part.

* * * * * * * *

Table I

Targeted and Actual Growth of
Money and Bank Credit

(Percent changes, at seasonally adjusted annual rates)

	FOMC Objective 1981Q4 to 1982Q4	Actual Growth 1981Q4 to June '82	1981Q4 to 1982Q2	1981H1 to 1982H1
M1	2-1/2 to 5-1/2	5.6	6.8	4.7**
M2	6 to 9	9.4	9.7	9.7
M3	6-1/2 to 9-1/2	9.7	9.8	10.5
Bank Credit*	6 to 9	8.0	8.3	8.4

* The base for the bank credit target is the average level of December 1981 and January 1982, rather than the average for 1981Q4. This base was adopted because of the impact on the series of shifts of assets to the new international banking facilities (IBFs); the 1981H1-to-1982H1 figure has been adjusted for the impact of the initial shifting of assets to IBFs.

** Adjusted for impact of shifts to new NOW accounts in 1981.

Appendix

Alternative Seasonal Adjustment Procedure

For some time the Federal Reserve has been investigating ways to improve its procedures for seasonal adjustment, particularly as they apply to the monetary aggregates. In June of last year, a group of prominent outside experts, asked by the Board to examine seasonal adjustment techniques, submitted their recommendations.[1/] The committee suggested, among other things, that the Board's staff develop seasonal factor estimates from a model-based procedure as an alternative to the widely used X-11 technique that provides the basis for the current seasonal adjustment procedure,[2/] and release the results.

The Board staff has been developing a procedure using statistical models tailored to each individual series.[3/] The table on the last page compares monthly and quarterly average growth rates for the current M1 series with those of an alternative series from the model-based approach.

Differences in seasonal adjustment techniques do not change the trend in monetary growth, but, as may be seen in the table, they do alter month-to-month growth rates owing to differing estimates of the

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1/ See Committee of Experts on Seasonal Adjustment Techniques, Seasonal Adjustment of the Monetary Aggregates (Board of Governors of the Federal Reserve System, October 1981).

2/ The current seasonal adjustment technique has most recently been summarized in the description to the mimeograph release of historical money stock data dated March 1982. Detailed descriptions of the X-11 program and variants can be obtained from technical paper no. 15 of the U. S. Department of Commerce (rev. February 1967) and from the report to the Board cited in footnote 1.

3/ The model-based seasonal adjustment procedures currently under review by the Board staff use methods based on the well-developed theory of statistical regression and time series modeling. These approaches allow development of seasonal factors that are more sensitive than the current factors to unique characteristics of each series, including, for example, fixed and evolving seasonal patterns, trading day effects, within-month seasonal variations, holiday effects, outlier adjustments, special events adjustments (such as the 1980 credit controls experience), and serially correlated noise components.

distribution over time of the seasonal component in money behavior. Short-run money growth is variable under both the alternative and current techniques of seasonal adjustment, illustrating the inherently large "noise" component of the series. However, the redistribution of the seasonal component under the alternative technique does on average tend to moderate month-to-month changes somewhat.

The Board will continue to publish seasonally adjusted estimates for M1 on both current and alternative bases at least until the annual review of seasonal factors in 1983. A detailed description of the alternative method will be available shortly.

Growth Rates of M1 Using
Current[1] and Alternative[2]
Seasonal Adjustment Procedures
(Monthly Average - Percent Annual Rates)

	1981			1982	
	Current	Alternative		Current	Alternative
Jan.	9.8	1.4	Jan.	21.0	11.4
Feb.	4.3	7.5	Feb.	-3.5	1.3
Mar.	14.3	16.0	Mar.	2.7	6.4
Apr.	25.2	22.6	Apr.	11.0	4.5
May	-11.4	-10.3	May	-2.4	0.5
June	-2.2	-0.6	June	-1.6	1.3
July	2.8	2.2			
Aug.	4.8	5.3			
Sept.	0.3	3.1			
Oct.	4.7	0.0			
Nov.	9.7	11.1			
Dec.	12.4	13.4			
	(Quarterly Average - Percent Annual Rates)				
QI	4.6	3.5	QI	10.4	9.5
QII	9.2	9.6	QII	3.1	3.4
QIII	0.3	0.9			
QIV	5.7	5.5			

1/ Current monthly seasonal factors are derived using an X-11/ARIMA-based procedure applied to monthly data.

2/ Alternative monthly seasonal factors are derived using a model-based procedure applied to weekly data.

For use at 9:30 a.m., E.D.T.
July 20, 1982

Board of Governors of the Federal Reserve System

Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 20, 1982

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1982

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

TABLE OF CONTENTS

Page

Section 1: The Performance of the Economy in the First Half of 1982..... 1

Section 2: The Growth of Money and Credit in the First Half of 1982..... 12

Section 3: The Federal Reserve's Objectives for Growth of Money and Credit..... 17

Section 4: The Outlook for the Economy..... 21

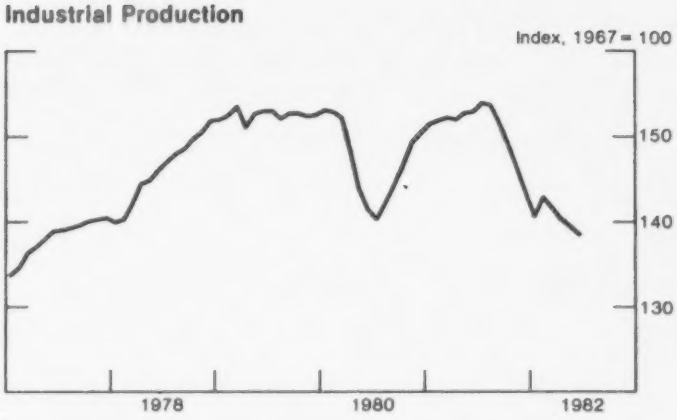
Section 1: The Performance of the Economy in the First Half of 1982

The contraction in economic activity that began in mid-1981 continued into the first half of 1982, although at a diminished pace. Declines in production and employment slowed, while sales of automobiles improved. Real GNP fell at a 4 percent annual rate between the third quarter of 1981 and the first quarter of 1982. With output declining, the margin of unused plant capacity widened and the unemployment rate rose to a postwar record.

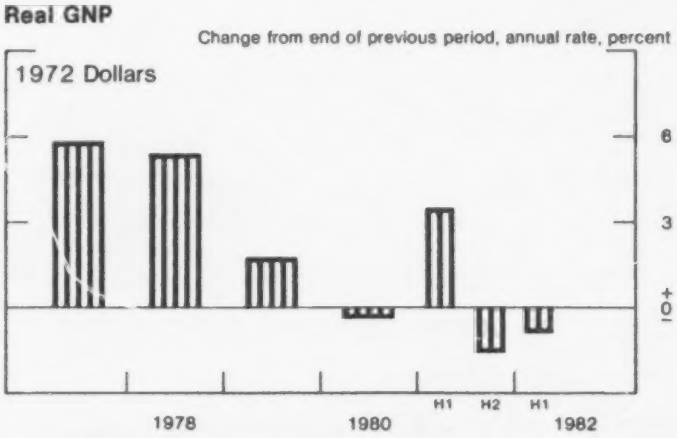
By mid-1982, however, the recession seemed to be drawing to a close. Inventory positions had improved substantially, homebuilding was beginning to revive, and consumer spending appeared to be rising. Nonetheless, there were signs of increased weakness in business investment. Although final demands apparently fell during the second quarter, the rate of inventory liquidation slowed, and on balance, real GNP apparently changed little. If, in fact, this spring or early summer is determined to have been the cyclical trough, both the depth and duration of the decline in activity will have been about the same as in other postwar recessions.

The progress in reducing inflation that began during 1981 continued in the first half of 1982. The greatest improvement was in prices of food and energy--which benefited from favorable supply conditions--but increases in price measures that exclude these volatile items also have slowed markedly. Moreover, increases in employment costs, which carry forward the momentum of inflation, have diminished considerably. Not only have wage increases eased for union workers in hardpressed industries as a result of contract concessions, but wage and fringe benefit increases also have slowed for non-union and white-collar workers in a broad range of

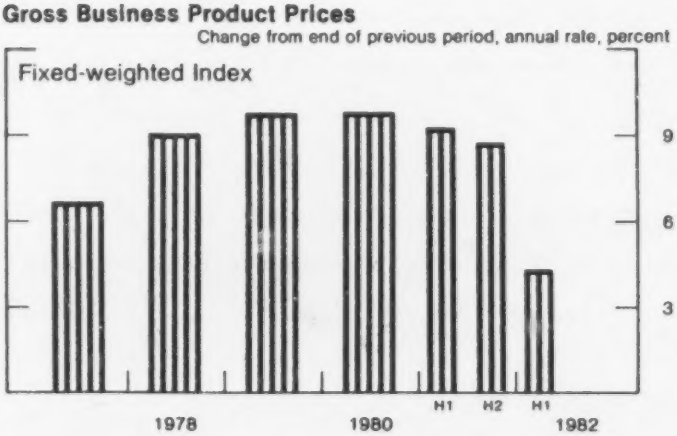
Industrial Production



Real GNP



Gross Business Product Prices



Note: Data for 1982 H1 are partially estimated by the FRB.

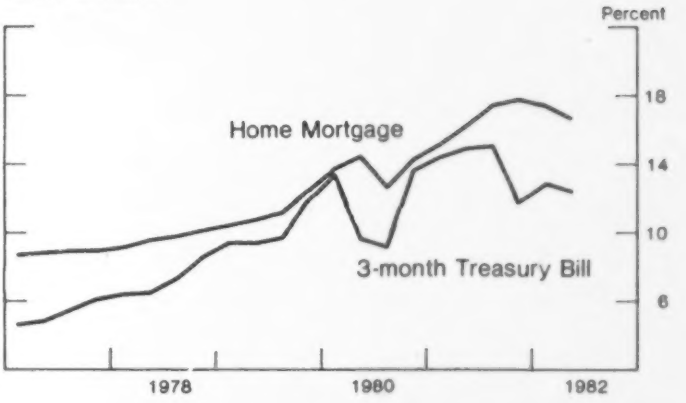
industries. In addition there has been increasing use of negotiated work-rule changes as well as other efforts by business to enhance productivity and trim costs. At the same time, purchasing power has been rising; real compensation per hour increased 1 percent during 1981 and rose at about a 3 percent annual rate over the first half of 1982.

Interest rates. As the recession developed in the autumn of 1981, short-term interest rates moved down substantially. However, part of this decline was retraced at the turn of the year as the demand for money bulged and reserve positions tightened. After the middle of the first quarter, short-term rates fluctuated but generally trended downward, as money--particularly the narrow measure, M1--grew slowly on average and the weakness in economic activity continued. In mid-July, short-term rates were distinctly below the peak levels reached in 1980 and 1981. Nonetheless, short-term rates were still quite high relative to the rate of inflation.

Long-term interest rates also remained high during the first half of 1982. In part, this reflected doubts by market participants that the improved price performance would be sustained over the longer run. This skepticism was related to the fact that, during the past two decades, episodes of reduced inflation have been short-lived, followed by reacceleration to even faster rates of price increase. High long-term rates also have been fostered by the prospect of huge deficits in the federal budget even as the economy recovers. Fears of deepening deficits have affected expectations of future credit market pressures, and perhaps also have sustained inflation expectations. The resolution on the 1983 fiscal year budget that

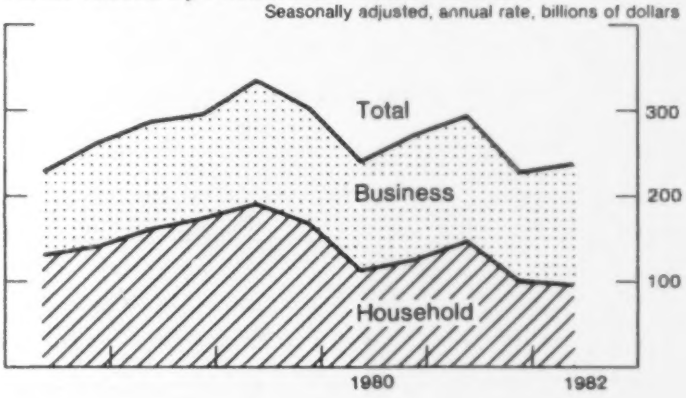
98-044 O - 82 -- 14

Interest Rates



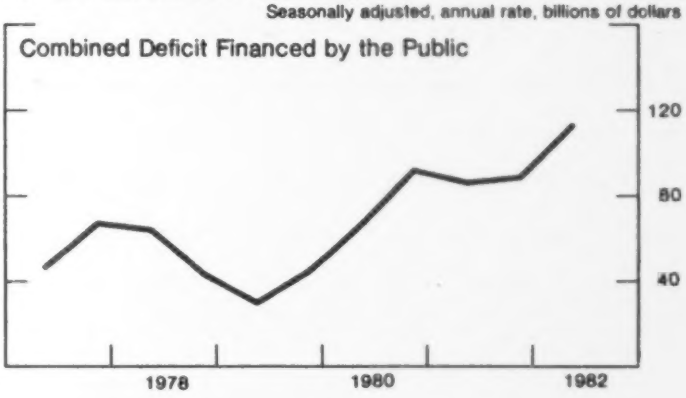
Funds Raised by Private Nonfinancial Sectors

Seasonally adjusted, annual rate, billions of dollars



Federal Government Borrowing

Seasonally adjusted, annual rate, billions of dollars



Note: Data for 1982 H1 are partially estimated by the FRB.

was adopted by the Congress represents a beginning effort to deal with the prospect of widening deficits; and the passage of implementing legislation should work in the direction of reducing market pressures on interest rates.

Domestic credit flows. Aggregate credit flows to private nonfinancial borrowers increased somewhat in the first half of 1982 from the reduced pace in the second half of 1981, according to very preliminary estimates. Business borrowing rose while households reduced further their use of credit. Borrowing by the federal government increased sharply in late 1981, after the 5 percent cut in personal income tax rates, and remained near the new higher level during the first half of 1982 on a seasonally adjusted basis. Reflecting uncertainties about the future economic and financial environment, both lenders and borrowers have shown a strong preference for short-term instruments.

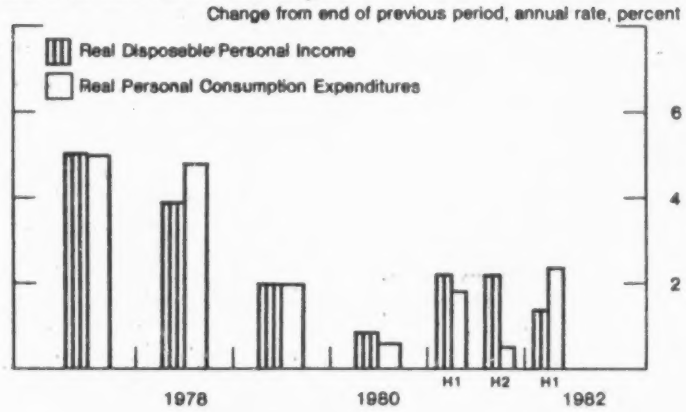
Much of the slackening in credit flows to nonfinancial sectors in the last part of 1981 was accounted for by households, particularly by household mortgage borrowing. Since then, mortgage credit flows have picked up slightly. The advance was encouraged in part by the gradual decline in mortgage rates from the peaks of last fall. In addition, households have made widespread use of adjustable-rate mortgages and "creative" financing techniques--including relatively short-term loans made by sellers at below-market interest rates and builder "buy-downs." About two-fifths of all conventional mortgage loans closed recently were adjustable-rate instruments, and nearly three-fourths of existing home transactions reportedly involved some sort of creative financing.

Business borrowing dropped sharply during the last quarter of 1981, primarily reflecting reduced inventory financing needs. However, credit use by nonfinancial corporations rose significantly in the first half of 1982, despite a further drop in capital expenditures. The high level of bond rates has discouraged corporations from issuing long-term debt, and a relatively large share of business borrowing this year has been accomplished in short-term markets--at banks and through sales of commercial paper. The persistently large volume of business borrowing suggests an accumulation of liquid assets as well as an intensification of financial pressures on at least some firms. Signs of corporate stress continue to mount, including increasing numbers of dividend reductions or suspensions, a rising fraction of business loans at commercial banks with interest or principal past due, and relatively frequent downgradings of credit ratings.

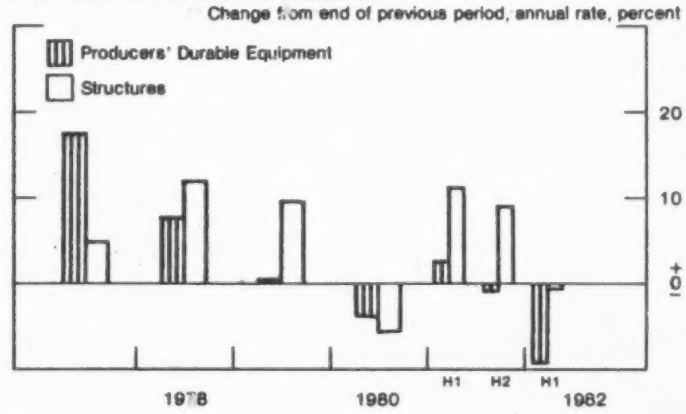
After raising a record volume of funds in U.S. credit markets in 1981, the federal government continued to borrow at an extraordinary pace during the first half of 1982, as receipts (national income and product accounts basis) fell while expenditures continued to rise. Owing to the second phase of the tax cut that went into effect on July 1 and the effects on tax revenues of the recession and reduced inflation, federal credit demands will expand further in the period ahead.

Consumption. Personal consumption expenditures (adjusted for inflation) fell sharply in the fourth quarter of 1981, but turned up early in 1982 and apparently strengthened further during the second quarter. The weakness in consumer outlays during the fourth quarter was concentrated in

Real Income and Consumption



Real Business Fixed Investment



Total Private Housing Starts

Note: Data for 1982 H1 are partially estimated by the FRB.

the auto sector, as total sales fell to an annual rate of 7.4 million units--the lowest quarterly figure in more than a decade--and sales of domestic models plummeted to a 5.1 million unit rate.

Price rebates and other sales promotion programs during the early months of 1982 provided a fillip to auto demand, and sales climbed to an 8.1 million unit rate. Auto markets remained firm into the spring, boosted in part by various purchase incentives. But as has generally occurred when major promotions have ended, auto purchases fell sharply in June. Outside the auto sector, retail sales at most types of stores were up significantly for the second quarter as a whole. Even purchases at furniture and appliance outlets, which had been on a downtrend since last autumn, increased during the spring.

Real after-tax income has continued to edge up, despite the sharp drop in output during the recession. The advance reflects not only typical cyclical increases in transfer payments but also the reduction in personal income tax rates on October 1. Households initially saved a sizable proportion of the tax cut, boosting the personal saving rate from 5-1/4 percent in mid-1981--about equal to the average of the late 1970s and early 1980s--to 6.1 percent in the fourth quarter of 1981. During early 1982, however, consumers increased spending, partly to take advantage of price markdowns for autos and apparel, and the saving rate fell.

Business investment. As typically occurs during a recession, the contraction in business fixed investment has lagged behind the decline in overall activity. Indeed, even though real GNP dropped substantially during the first quarter of 1982, real spending for fixed business capital

actually rose a bit. An especially buoyant element of the investment sector has been outlays for nonfarm buildings--most notably, commercial office buildings, for which appropriations and contracts often are set a year or more in advance.

In contrast to investment in structures, business spending for new equipment showed little advance during 1981 and weakened considerably in the first half of 1982. Excluding business purchases of new cars, which also were buoyed by rebate programs, real investment in producers' durable equipment fell at a 2 percent annual rate in the first quarter. The decline evidently accelerated in the second quarter. In April and May, shipments of nondefense capital goods, which account for about 80 percent of the spending on producers' durable equipment, averaged nearly 3 percent below the first-quarter level in nominal terms. Moreover, sales of heavy trucks dropped during the second quarter to a level more than 20 percent below the already depressed first-quarter average.

Businesses liquidated inventories at a rapid rate during late 1981 and in the first half of 1982. The adjustment of stocks followed a sizable buildup during the summer and autumn of last year that accompanied the contraction of sales. The most prominent inventory overhang by the end of 1981 was in the automobile sector as sales fell precipitously. However, with a combination of production cutbacks and sales promotions, the days' supply of unsold cars on dealers lots had improved considerably by spring.

Manufacturers and non-auto retailers also found their inventories rising rapidly last autumn. Since then, manufacturers as a whole have liquidated the accumulation that occurred during 1981, although some problem areas

still exist--particularly in primary metals. Stocks held by non-auto retailers have been brought down from their cyclical peak, but they remain above pre-recession levels.

Residential construction. Housing activity thus far in 1982 has picked up somewhat from the depressed level in late 1981. Housing starts during the first five months of 1982 were up 10 percent on average from the fourth quarter of 1981. The improvement in homebuilding has been supported by strong underlying demand for housing services in most markets and by the continued adaptation of real estate market participants to nontraditional financing techniques that facilitate transactions.

The turnaround in housing activity has not occurred in all areas of the country. In the south, home sales increased sharply in the first part of 1982, and housing starts rose 25 percent from the fourth quarter of 1981. In contrast, housing starts declined further, on average, during the first five months of 1982 in both the west and the industrial north central states.

Government. Federal government purchases of goods and services, measured in constant dollars, declined over the first half of 1982. The decrease occurred entirely in the nondefense area, primarily reflecting a sharp drop in the rate of inventory accumulation by the Commodity Credit Corporation during the spring quarter. Purchases by the Commodity Credit Corporation had reached record levels during the previous two quarters owing to last summer's large harvests and weak farm prices. Other nondefense outlays fell slightly over the first half of the year as a result of cuts in employment and other expenditures under many programs. Real

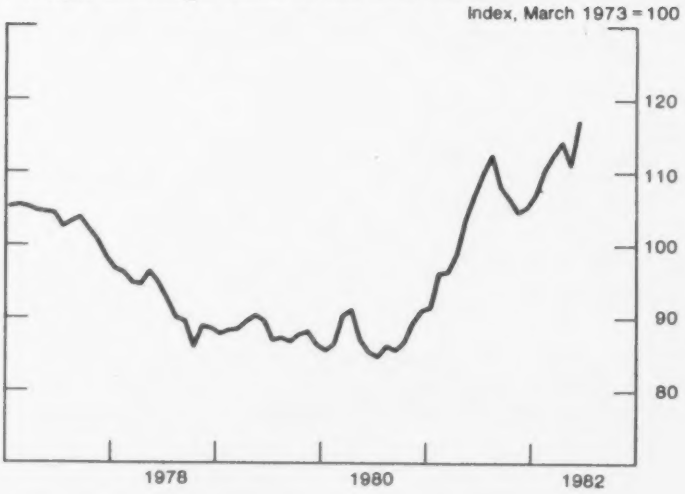
defense spending apparently rose over the first half of the year, and the backlog of unfilled orders grew further. The federal deficit on a national income and product account basis widened from $100 billion at the end of 1981 to about $130 billion during the spring of this year. Much of this increase in the deficit reflects the effects of the recession on federal expenditures and receipts.

At the state and local government level, real purchases of goods and services fell further over the first half of 1982 after having declined 2 percent during 1981. Most of the weakness this year has been in construction outlays as employment levels have stabilized after large reductions in the federally funded CETA program led to sizable layoffs last year. The declines in state and local government activity in part reflect fiscal strains associated with the withdrawal of federal support for many activities and the effects of cyclically sluggish income growth on tax receipts. Because of the serious revenue problems, several states have increased sales taxes and excise taxes on gasoline and alcohol.

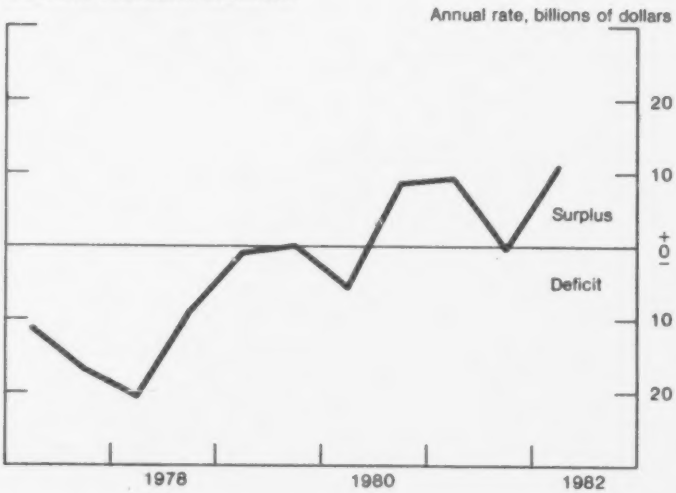
International payments and trade. The weighted-average value of the dollar, after declining about 10 percent from its peak last August, began to strengthen sharply again around the beginning of the year and since then has appreciated nearly 15 percent on balance. The appreciation of the dollar has been associated to a considerable extent with the declining inflation rate in the United States and the rise in dollar interest rates relative to yields on assets denominated in foreign currencies.

Reflecting the effects of the strengthening dollar, as well as the slowing of economic growth abroad, real exports of goods and services have

Foreign Exchange Value of the U.S. Dollar



Current Account Balance



Note: Data for 1982 H1 are partially estimated by the FRB.

been decreasing since the beginning of 1981. The volume of imports other than oil, which rose fairly steadily throughout last year, dropped sharply in the first half of 1982, owing to the weakness of aggregate demand--especially for inventories--in the United States. In addition, both the volume and price of imported oil fell during the first half of the year. The current account, which was in surplus for 1981 as a whole, recorded another surplus in the first half of this year as the value of imports fell more than the value of exports.

Labor markets. Employment has declined by nearly 1-1/2 million since the peak reached in mid-1981. As usually happens during a cyclical contraction, the largest job losses have been in durable goods manufacturing industries--such as autos, steel, and machinery--as well as at construction sites. The job losses in manufacturing and construction during this recession follow a limited recovery from the 1980 recession; as a result, employment levels in these industries are more than 10 percent below their 1979 highs. In addition, declines in aggregate demand have tempered the pace of hiring at service industries and trade establishments over the past year. As often happens near a business cycle trough, employment fell faster than output in early 1982 and labor productivity showed a small advance after declining sharply during the last half of 1981.

Since mid-1981 there has been a 2-1/4 percentage point rise in the overall unemployment rate to a postwar record high of 9-1/2 percent. The effects of the recession have been most severe in the durable goods and construction industries, and the burden of rising unemployment has been relatively heavy on adult men, who tend to be more concentrated in these

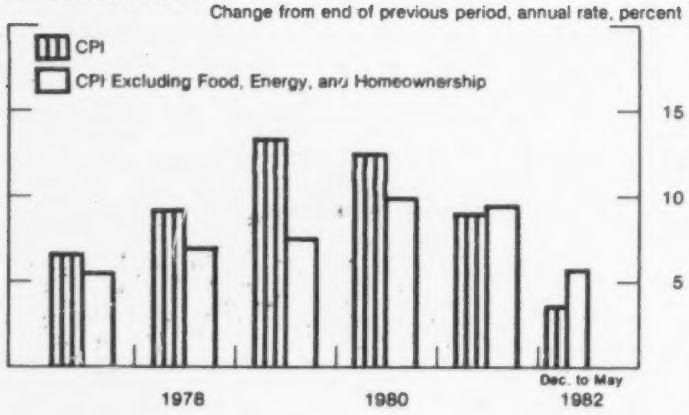
industries. At the same time, joblessness among young and inexperienced workers remains extremely high; hardest hit have been black male teenagers who experienced an umemployment rate of nearly 60 percent in June 1982.

Reflecting the persistent slack in labor markets, most indicators of labor supply also show a significant weakening. For example, the number of discouraged workers--that is, persons who report that they want work but are not looking for jobs because they believe they cannot find any--has increased by nearly half a million over the past year, continuing an upward trend that began before the 1980 recession. In addition, the labor force participation rate--the proportion of the working-age population that is employed or actively seeking jobs--has been essentially flat for the last two years after rising about one-half percentage point annually between 1975 and 1979.

Prices and labor costs. A slowing in the pace of inflation, which was evident during 1981, continued through the first half of this year. During the first five months of 1982 (the latest data available), the consumer price index increased at an annual rate of 3.5 percent, sharply lower than the 8.9 percent rise during 1981. Much of the improvement was in energy and food prices as well as in the volatile CPI measure of home-ownership costs. But even excluding these items, the annual rate of increase in consumer prices has slowed to 5-1/2 percent this year compared with a 9-1/2 percent rise last year. The moderation of price increases also was evident at the producer level. Prices of capital equipment have increased at a 4-1/4 percent annual rate thus far this year--well below the 9-1/4 percent pace of 1981. In addition, the decline in raw materials prices, which occurred throughout last year, has continued in the first half of 1982.

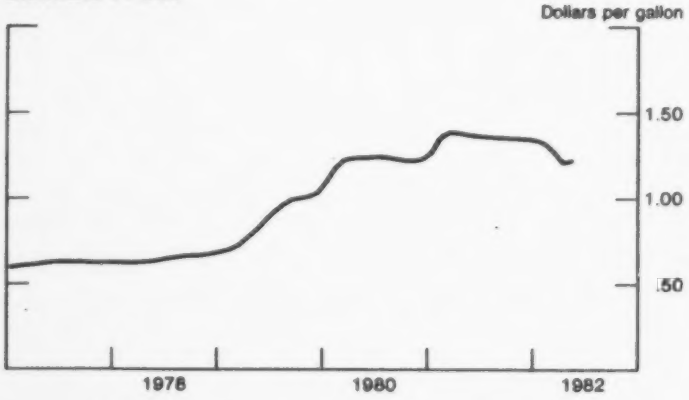
Consumer Prices

Change from end of previous period, annual rate, percent



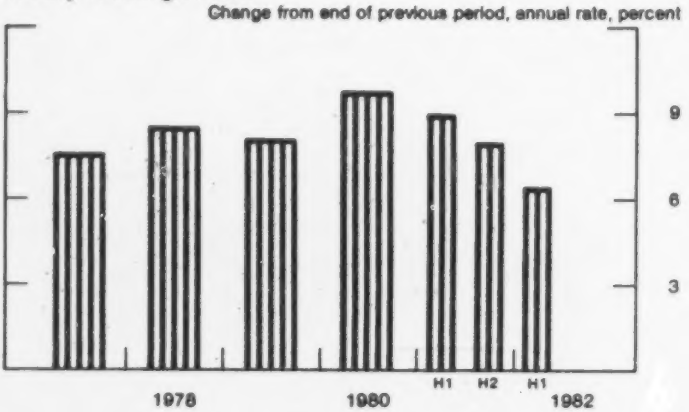
Gasoline Prices

Dollars per gallon



Hourly Earnings Index

Change from end of previous period, annual rate, percent



Gasoline prices at the retail level, which had remained virtually flat over the second half of 1981, fell substantially during the first four months of 1982. Slack domestic demand and an overhang of stocks on world petroleum markets precipitated the decline in prices. However, gasoline prices began to rise again in May in reflection of rising consumption, reduced stocks, and lower production schedules by major crude oil suppliers.

The rate of increase in employment costs decelerated considerably during the first half of 1982. The index of average hourly earnings, a measure of wage trends for production and nonsupervisory personnel, rose at a 6-1/4 percent annual rate over the first half of this year, compared with an increase of 8-1/4 percent during 1981. Part of the slowing was due to early negotiation of expiring contracts and renegotiation of existing contracts in a number of major industries. These wage concessions are expected to relieve cost pressures and to enhance the competitive position of firms in these industries. Increases in fringe benefits, which generally have risen faster than wages over the years, also are being scaled back. Because wage demands, not to mention direct escaltor provisions, are responsive to price performance, the progress made in reducing the rate of inflation should contribute to further moderation in labor cost pressures.

Section 2: The Growth of Money and Credit in the First Half of 1982

The annual targets for the monetary aggregates announced in February were chosen to be consistent with continued restraint on the growth of money and credit in order to exert sustained downward pressure on inflation. At the same time, these targets were expected to result in sufficient money growth to support an upturn in economic activity. Measured from the fourth quarter of 1981 to the fourth quarter of 1982, the growth ranges for the aggregates adopted by the Federal Open Market Committee (FOMC) were as follows: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The corresponding range specified by the FOMC for bank credit was 6 to 9 percent.[1]

When the FOMC was deliberating on its annual targets in February, the Committee was aware that M1 already had risen well above its average level in the fourth quarter of 1981. In light of the financial and economic backdrop against which the bulge in M1 had occurred, the Committee believed it likely that there had been an upsurge in the public's demand for liquidity. It also seemed probable that this strengthening of money demand would unwind in the months ahead. Thus, under these circumstances and given the relatively low base for the M1 range for 1982, it did not appear appropriate to seek an abrupt return to the annual target range, and the FOMC indicated its willingness to permit M1 to remain above the range for a while. At the

1. Because of the authorization of international banking facilities (IBFs) on December 3, 1981, the bank credit data starting in December 1981 are not comparable with earlier data. The target for bank credit was put in terms of annualized growth measured from the average of December 1981 and January 1982 to the average level in the fourth quarter of 1982 so that the shift of assets to IBFs that occurred at the turn of the year would not have a major impact on the pattern of growth.

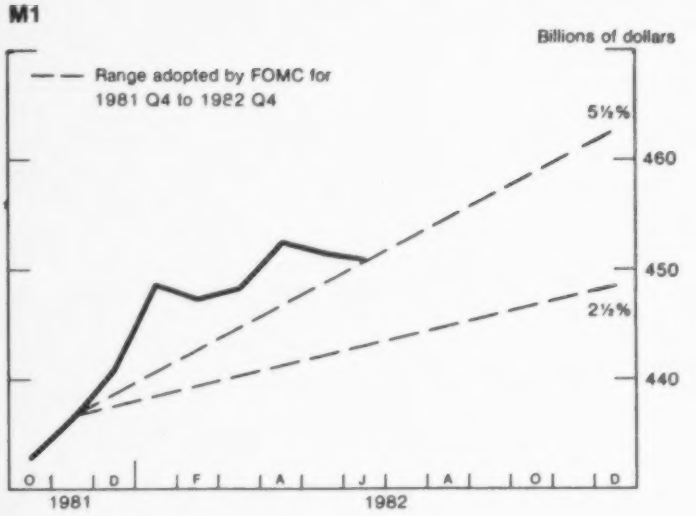
same time, the FOMC agreed that the expansion in M1 for the year as a whole might appropriately be in the upper part of its range, particularly if available evidence suggested the persistence of unusual desires for liquidity that had to be accommodated to avoid undue financial stringency.

In setting the annual target for M2, the FOMC indicated that M2 growth for the year as a whole probably would be in the upper part of its annual range and might slightly exceed the upper limit. The Committee anticipated that demands for the assets included in M2 might be enhanced by new tax incentives such as the broadened eligibility for IRA/Keogh accounts, or by further deregulation of deposit rates. The Committee expected that M3 growth again would be influenced importantly by the pattern of business financing and, in particular, by the degree to which borrowing would be focused in markets for short-term credit.

As anticipated--and consistent with the FOMC's short-run targets--the surge in M1 growth in December and January was followed by appreciably slower growth. After January, M1 increased at an annual rate of only 1-1/4 percent on average, and the level of M1 in June was only slightly above the upper end of the Committee's annual growth range. From the fourth quarter of 1981 to June, M1 increased at a 5.6 percent annual rate. M2 growth so far this year also has run a bit above the FOMC's annual range; from the fourth quarter of 1981 through June, M2 increased on average at a 9.4 percent annual rate. From a somewhat longer perspective, M1 has increased at a 4.7 percent annual rate, measuring growth from the first half of 1981

Ranges and Actual Monetary Growth

M1



Annual Rates of Growth

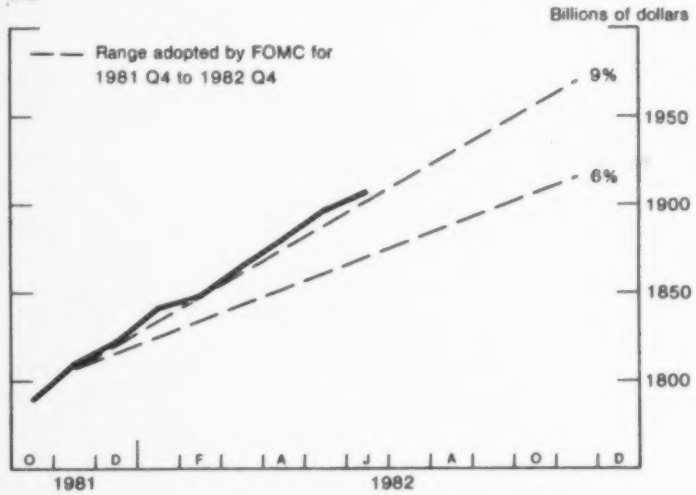
1981 Q4 to June
5.6 Percent

1981 Q4 to 1982 Q2
6.8 Percent

1981 H1 to 1982 H1
4.7 Percent [1]

[1] Adjusted for shifts into new NOW accounts in 1981.

M2



Annual Rates of Growth

1981 Q4 to June
9.4 Percent

1981 Q4 to 1982 Q2
9.7 Percent

1981 H1 to 1982 H1
9.7 Percent

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to the first half of 1982 and abstracting from the shift into NOW accounts in 1981; and M2 has grown at a 9.7 percent annual rate on a half-year over half-year basis.

Although M1 growth has been moderate on balance thus far this year, that growth has considerably exceeded the pace of increase in nominal GNP. Indeed, the first-quarter decline in the income velocity of M1--that is, GNP divided by M1--was extraordinarily sharp. Similarly, the velocity of the broader aggregates has been unusually weak. Given the persistence of high interest rates, this pattern of velocity behavior suggests a heightened demand for M1 and M2 over the first half.

The unusual demand for M1 has been focused on its NOW account component. Following the nationwide authorization of NOW accounts at the beginning of 1981, the growth of such deposits surged. When the aggregate targets were reviewed this past February, a variety of evidence indicated that the major shift from conventional checking and savings accounts into NOW accounts was over; in particular, the rate at which new accounts were being opened had dropped off considerably. As a result of that shift, however, NOW accounts and other interest-bearing checkable deposits had grown to account for almost 20 percent of M1 by the beginning of 1982. Subsequently, it has become increasingly apparent that M1 is more sensitive to changes in the public's desire to hold highly liquid assets.

M1 is intended to be a measure of money balances held primarily for transaction purposes. However, in contrast to the other major components of M1--currency and conventional checking accounts--NOW accounts

also have some characteristics of traditional savings accounts. Apparently reflecting precautionary motives to a considerable degree, NOW accounts and other interest-bearing checkable deposits grew surprisingly rapidly in the fourth quarter of last year and the first quarter of this year. Although growth in this component has slowed recently, its growth from the fourth quarter of last year to June has been 30 percent at an annual rate. The other components of M1 increased at an annual rate of less than 1 percent over this same period.

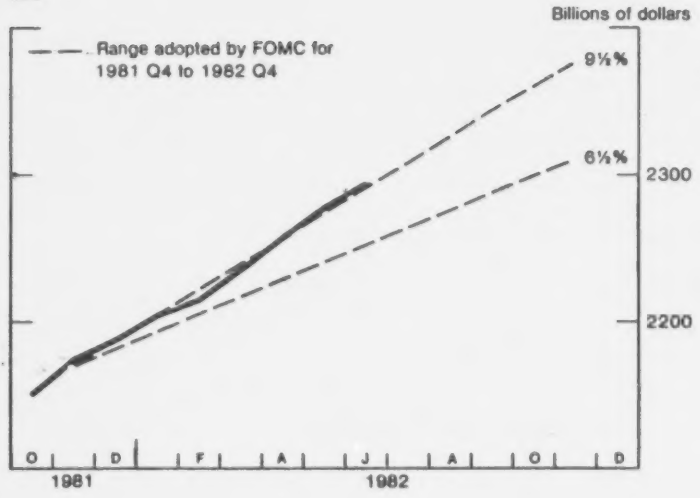
Looking at the components of M2 not also included in M1, the so-called nontransaction components, these items grew at a 10-3/4 percent annual rate from the fourth quarter to June. General purpose and broker/dealer money market mutual funds were an especially strong component of M2, increasing at almost a 30 percent annual rate this year. Compared with last year, however, when the assets of such money funds more than doubled, this year's increase represents a sharp deceleration.

Perhaps the most surprising development affecting M2 has been the behavior of conventional savings deposits. After declining in each of the past four years--falling 16 percent last year--savings deposits have increased at about a 4 percent annual rate thus far this year. This turnaround in savings deposit flows, taken together with the strong increase in NOW accounts and the still substantial growth in money funds, suggests that stronger preferences to hold safe and highly liquid financial assets in the current recessionary environment are bolstering the demand for M2 as well as M1.

M3 increased at a 9.7 percent annual rate from the fourth quarter of 1981 to June, just above the upper end of the FOMC's annual growth target.

Ranges and Actual Monetary Growth

M3



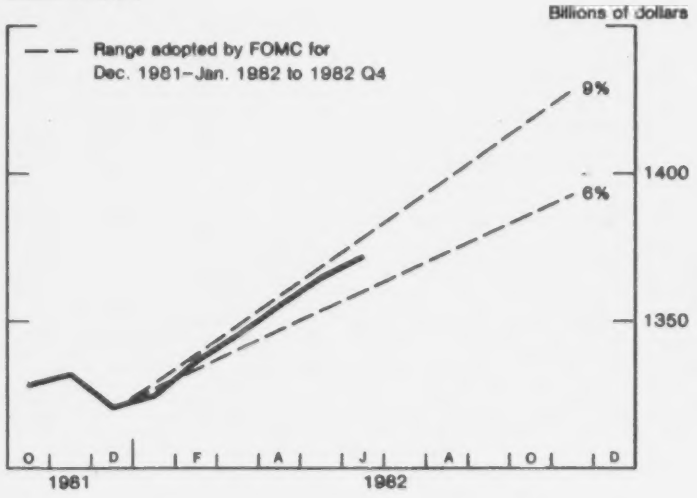
Annual Rates of Growth

1981 Q4 to June
9.7 Percent

1981 Q4 to 1982 Q2
9.8 Percent

1981 H1 to 1982 H1
10.5 Percent

Bank Credit



Annual Rates of Growth

Dec.–Jan. to June
8.0 Percent

Dec.–Jan. to 1982 Q2
8.3 Percent

1981 H1 to 1982 H1
8.4 Percent[1]

[1] Adjusted for initial shifts into international banking facilities.

Early in the year, M3 growth was relatively moderate as a strong rise in large-denomination CDs was offset by declines in term RPs and in money market mutual funds restricted to institutional investors. During the second quarter, however, M3 showed a larger increase; the weakness in its term RP and money fund components subsided and heavy issuance of large CDs continued. With growth of "core deposits" relatively weak on average, commercial banks borrowed heavily in the form of large CDs to fund the increase in their loans and investments.

Commercial bank credit grew at an 8.3 percent annual rate over the first half of the year, in the upper part of the FOMC's range for 1982. Bank loans have increased on average at about a 9-1/2 percent annual rate, with loans to nonfinancial businesses expanding at a 14 percent annual rate. In past economic downturns, business loan demand at banks has tended to weaken, but consistently high long-term interest rates in the current recession have induced corporations to meet the great bulk of their external financing needs through short-term borrowing. Real estate loans have increased at a 7-1/4 percent annual rate this year, somewhat slower than the growth in each of the past two years. Consumer loans outstanding during the first half of the year have grown at the same sluggish pace of 3 percent experienced last year. The investment portfolios of banks have expanded at about a 5 percent annual rate, with the rate of increase in U.S. government obligations about twice as large as the growth in holdings of other types of securities.

Section 3: The Federal Reserve's Objectives for Growth of Money and Credit

There is a clear need today to promote higher levels of production and employment in our economy. The objective of Federal Reserve policy is to create an environment conducive to sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability. The experience of the past two decades has amply demonstrated the destructive impact of inflation on economic performance. Because inflation cannot persist without excessive monetary expansion, appropriately restrained growth of money and credit over the longer run is critical to achieving lasting prosperity.

The policy of firm restraint on monetary growth has contributed importantly to the recent progress toward reducing inflation. But when inflationary cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses, especially when so much of the burden of dealing with inflation rests on monetary policy. These strains--reflected in reduced profits, liquidity problems, and balance-sheet pressures--place particular hardships on industries that depend heavily on credit markets such as construction, business equipment, and consumer durables.

Unfortunately, these stresses cannot be easily remedied through accelerated money growth. The immediate effect of encouraging faster growth in money might be lower interest rates, especially in short-term markets. In time, however, the attempt to drive interest rates lower through a substantial reacceleration of money growth would founder, for the result would be to embed inflation and expectations of inflation even more deeply into

the nation's economic system. It would mean that this recession was another wasted, painful episode instead of a transition to a sustained improvement in the economic environment. The present and prospective pressures on financial markets urgently need to be eased not by relaxing discipline on money growth, but by the adoption of policies that will ensure a lower and declining federal deficit. Moreover, a return to financial health will require the adoption of more prudent credit practices on the part of private borrowers and lenders alike.

In reviewing its targets for 1982 and setting tentative targets for 1983, the FOMC had as its basic objective the maintenance of the longer-range thrust of monetary discipline in order to reduce inflation further, while providing sufficient money growth to accommodate exceptional liquidity pressures and support a sustainable recovery in economic activity. At the same time, the Committee recognized that regulatory actions or changes in the public's financial behavior might alter the implications of any quantitative monetary goals in ways that cannot be fully predicted.

In light of all these considerations, the Committee concluded that a change in the previously announced targets was not warranted at this time. Because of the tendency for the demand for money to run strong on average in the first half, and also responding to the congressional budget resolution, careful consideration was given to the question of whether some raising of the targets was in order. However, the available evidence did not suggest that a large increase in the ranges was justified, and a small change in the ranges would have represented a degree of "fine tuning" that

appeared inconsistent with the degree of uncertainty surrounding the precise relationship of money to other economic variables at this time. However, the Committee concluded, based on current evidence, that growth this year around the top of the ranges for the various aggregates would be acceptable.

The Committee also agreed that possible shifts in the demand for liquidity in current economic circumstances might require more than ordinary elements of flexibility and judgment in assessing appropriate needs for money in the months ahead. In the near term, measured growth of the aggregates may be affected by the income tax reductions that occurred on July 1, by cost-of-living increases in social security benefits, and by the ongoing difficulties of accurately accounting for seasonal movements in the money stock. But more fundamentally, it is unclear to what degree businesses and households may continue to wish to hold unusually large precautionary liquid balances. To the extent the evidence suggests that relatively strong precautionary demands for money persist, growth of the aggregates somewhat above their targeted ranges would be tolerated for a time and still would be consistent with the FOMC's general policy thrust.

Looking ahead to 1983 and beyond, the FOMC remains committed to restraining money growth in order to achieve sustained noninflationary economic expansion. At this point, the FOMC feels that the ranges now in effect can appropriately remain as preliminary targets for 1983. Because monetary aggregates in 1982 more likely than not will be close to the upper ends of their ranges, or perhaps even somewhat above them, the

preliminary 1983 targets would be fully consistent with a reduction in the actual growth of money in 1983.

In light of the unusual uncertainty surrounding the economic, financial, and budgetary outlook, the FOMC stressed the tentative nature of its 1983 targets. On the one hand, postwar cyclical experience strongly suggests that some reversal of this year's unusual shift in the asset-holding preferences of the public could be expected; with economic activity on an upward trend, any lingering precautionary motives for holding liquid balances should begin to fade, thus contributing to a rapid rise in the velocity of money. Moreover, regulatory actions by the Depository Institutions Deregulation Committee that increase the competitive appeal of deposit instruments--as well as the more widespread use of innovative cash management techniques, such as "sweep" accounts--also could reduce the demand for money relative to income and interest rates. On the other hand, factors exist that should increase the attractiveness of holding cash balances. The long upward trend in the velocity of money since the 1950s took place in an environment of rising inflation and higher nominal interest rates--developments that provide incentives for economizing on money holdings. As these incentives recede, it is possible that the attractiveness of cash holdings will be enhanced and that more money will be held relative to the level of business activity.

Section 4: The Outlook for the Economy

The economy at midyear appears to have leveled off after sizable declines last fall and winter. Consumption has strengthened with retail sales up significantly in the second quarter. New and existing home sales have continued to fluctuate at depressed levels, but housing starts nonetheless have edged up. In the business sector, substantial progress has been made in working off excess inventories, and the rate of liquidation appears to have declined. On the negative side, however, plant and equipment spending, which typically lags an upturn in overall activity, is still depressed. And the trend in export demand continues to be a drag on the economy, reflecting the dollar's strength and weak economic activity abroad.

An evaluation of the balance of economic forces indicates that an upturn in economic activity is highly likely in the second half of 1982. Monetary growth along the lines targeted by the FOMC should accommodate this expansion in real GNP, given the increases in velocity that typically occur early in a cyclical recovery and absent an appreciable resurgence of inflation. The 10 percent cut in income tax rates that went into effect July 1 is boosting disposable personal income and should reinforce the growth in consumer spending. Given the improved inventory situation, any sizable increase in consumer spending should, in turn, be reflected in new orders and a pickup in production. Another element supporting growth in real GNP will be the continuing rise in defense spending and the associated private investment outlays needed for the production of defense equipment.

At least during the initial phase, the expansion is likely to be more heavily concentrated in consumer spending than in past business cycles, as current pressures in financial markets and liquidity strains may inhibit the recovery in investment activity. With mortgage interest rates high, residential construction does not seem likely to contribute to the cyclical recovery to the extent that it has in the past. Likewise, the high level of corporate bond rates, and the cumulative deterioration in corporate balance sheets resulting from reliance in recent years on short-term borrowing, may restrain capital spending, especially given the considerable margin of unutilized capacity that now exists.

The excellent price performance so far this year has been helped by slack demand and by exceptionally favorable energy and food supply developments. For that reason, the recorded rate of inflation may be higher in the second half. However, prospects appear excellent for continuing the downtrend in the underlying rate of inflation. As noted earlier, significant progress has been made in slowing the rise in labor compensation, and improvement in underlying cost pressures should continue over the balance of the year. Unit labor costs also are likely to be held down by a cyclical rebound in productivity growth as output recovers. Moreover, lower inflation will contribute to smaller cost-of-living wage adjustments, which will moderate cost pressures further.

The Federal Reserve's objectives for money growth through the end of 1983 are designed to be consistent with continuing recovery in economic activity. A critical factor influencing the composition and strength of the expansion will be the extent to which pressures in financial markets

moderate. This, in turn, depends importantly on the progress made in further reducing inflationary pressures. A marked decrease in inflation would take pressure off financial markets in two ways. First, slower inflation will lead to a reduced growth in transaction demands for money, given any particular level of real activity. It follows that a given target for money growth can be achieved with less pressure on interest rates and accordingly less restraint on real activity, the greater is the reduction in inflation. Second, further progress in curbing inflation will help lower long-term interest rates by reducing the inflation premium contained in nominal interest rates. The welcome relief in inflation seen recently apparently is assumed by many to represent a cyclical rather than a sustained drop in inflation. But the longer that improved price performance is maintained, the greater will be the confidence that a decisive downtrend in inflation is being achieved. Such a change should be reflected in lower long-term interest rates and stronger activity in the interest-sensitive sectors of the economy.

Another crucial influence on financial markets and thus on the nature of the expansion in 1983 will be the federal budgetary decisions that are made in coming months. The budget resolution that was recently passed by the House and Senate is a constructive first step in reducing budget deficits as the economy recovers. However, much remains to be done in appropriation and revenue legislation to implement this resolution. How the budgetary process unfolds will be an important factor in determining future credit demands by the federal government and thus the extent to which deficits will preempt the net savings generated by the private economy. A strong program of budget restraint would minimize pressures in financial

markets and thereby enhance the prospects for a more vigorous recovery in homebuilding, business fixed investment, and other credit-dependent sectors.

In assessing the economic outlook, the individual members of the FOMC have formulated projections for several key measures of economic performance that fall generally within the ranges in the table below. In addition to the monetary aggregate objectives discussed earlier, these projections assume that the federal budget will be put on a course that over time will result in significant reductions in the federal deficit.

ECONOMIC PROJECTIONS OF FOMC MEMBERS

	Actual	Projected	
	1981	1982	1983
Changes, fourth quarter to fourth quarter, percent			
Nominal GNP	9.8	5-1/2 to 7-1/2	7 to 9-1/2
Real GNP	0.9	1/2 to 1-1/2	2-1/2 to 4
GNP deflator	8.9	4-3/4 to 6	4 to 5-3/4
Average level in the fourth quarter, percent			
Unemployment rate	8.3	9 to 9-3/4	3-1/2 to 9-1/2

Revised administration forecasts for the economy were not available at the time of the Committee's deliberation. Our understanding, however, is that the administration's midyear budgetary review will be presented within the framework of the economic assumptions used in the first budget resolution. For the remainder of 1982, those assumptions imply somewhat more rapid recovery than the range now thought most likely by members of the FOMC, but would be consistent with the monetary targets outlined in this report on the assumption of growth in velocity characteristic of the early stages of a

number of past recoveries. Looking further ahead, the Committee members, like the administration and the Congress, foresee continued economic expansion in 1983, but currently anticipate a less rapid rate of price increase and somewhat slower real growth than the assumptions underlying the budget. The monetary targets tentatively set for 1983, which will be reviewed early next year, would imply, under the budgetary assumptions, relatively high growth in velocity.

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